Supreme Court, U.S.
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No.

IN THE

SUPREME COURT OF THE UNITED STATES

In re: WORTH A. SALLEE and
SANDRA M. SALLEE,

Debtors

WORTH A. SALLEE,
SANDRA M. SALLEE, and
JOHN WILSON, Trustee,

Petitioners

versus

FORT KNOX NATIONAL BANK, N.A. and
DICKINSON FINANCIAL CORPORATION,

Respondents.

On Petition for a Writ of Certiorari to the
United States Court of Appeals for the Sixth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

The questions presented by this case are controlled by Kentucky law. It provides that for every injury, including an injury fraudulently induced, there is a remedy. Moreover, it provides that banks which provide services in addition to traditional lending may be fiduciaries. A panel of the Sixth Circuit, composed entirely of Ohio judges, ignored these clear precepts. Despite affirming that the Petitioner Sallees were defrauded as to the establishment of an IRA the Circuit Court held that the Sallees were not entitled to damages for that fraud and further that the bank, in failing to establish the IRA, did not become their fiduciary.

The questions presented are:

1. Whether that panel of the Sixth Circuit ignored and/or misinterpreted Kentucky's law of damages and denied the Sallees a remedy and recovery of damages for fraud; and

2. Whether that panel of the Sixth Circuit ignored both Kentucky law and federal common law as found by the Seventh Circuit in finding that the relationship between a bank and a customer involving an IRA account is not fiduciary in nature.

STATEMENT PURSUANT TO RULE 29.6

The Petitioners, Worth A. and Sandra M. Sallee, and John Wilson, Trustee for the Estate of Worth A. and Sandra M. Sallee, state that they are respectively individual residents of the State of Kentucky, and an estate created under the provisions of Title 11, U.S.C. They state that neither Respondent has publicly traded stock.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners respectfully petition for a writ of certiorari to review the Judgment and Opinion of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The Memorandum Opinion and Judgment of the bankruptcy court (Appendix D) and the district court's Memorandum Opinion, Order and Judgment (Appendix C) are not published. The Opinion of the United States Court of Appeals for the Sixth Circuit is published at 286 F.3rd 878. (Appendix B) The order of the Court of Appeals denying rehearing is not published. (Appendix A)

STATEMENT OF JURISDICTION

The Court of Appeals entered its Opinion and Order on April 15, 2002. Rehearing was denied May 10, 2002. Petitioners invoke this Court's jurisdiction under the provisions of 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

26 U.S.C. § 402(c)
26 U.S.C. § 408(a)

STATEMENT OF THE CASE

Because this factually complex case was appealed on the record from the Bankruptcy Court, the Sixth Circuit relied upon the Bankruptcy Court's factual findings, which were not directly challenged by Fort Knox National Bank [FKNB]. The Petitioners, who were defrauded by FKNB, will briefly state the case based upon the actual findings of the Bankruptcy Court:

I. Fort Knox National Bank Expands and Lends to Fred W. Bramblett

- "FKNB was, prior to its acquisition by DFC [Dickinson Financial Corporation, its holding company], a small banking institution located on the military post of Fort Knox, Kentucky. Its primary business was to provide a wide range of consumer banking services to Fort Knox military personnel and the citizens of the surrounding communities of Radcliff, Kentucky." (App. D, p. 71a)
- "However, in mid to late1980's, like a large number of other lending institutions, FKNB decided to increase its commercial lending, which ultimately grew to approximately 40% of FKNB total loan portfolio." (App. D, p. 71a)
- "Unfortunately for FKNB, at approximately the same time they decided to increase their commercial lending, Fred W. Bramblett ("FWB") decided to become a real estate developer." (App. D, p. 71a)
- "During the Spring of 1987, FWB continued to expand his construction business with the enthusiastic assistance of FKNB." (App. D, p. 73a)
- "In the Winter of 1987 FWB's construction/real estate empire began to crumble. ***Logsdon [senior commercial lender at FKNB] admitted that FKNB was aware of FWB's financial problems." (App. D, p. 74a)
- "Sometime in late January of 1988, FWB went to see Logsdon and informed him that he was broke and was planning to file bankruptcy." (App. D, p. 75a)
- "This Court finds that, whatever the details, FWB and Logsdon agreed to a generalized workout strategy which would entail FWB, his businesses, various Bramblett family members, and other Bramblett associates obtaining more loans from FKNB to be used in part to keep FWB's various loans from going bad until either FWB could pay his obligation or sell his projects to satisfy his debt to FKNB." (App. D, p. 75a-76a)

II. The Sallees Begin a Relationship With FKNB

- "During the shopping center debacle [one of FWB's construction projects], the debtors Worth and Sandra Sallee, began their lending relationship with FKNB in August of 1988. At the time of their initial borrowing, Worth Sallee was a manager at Lowes in Clarksville, Indiana. He had been transferred there from his position as the Lowes manager in Elizabethtown, Kentucky. Worth was unhappy with his transfer and he and his wife were exploring the possibility of purchasing a business in Elizabethtown, Kentucky. The business they chose was a convenience food store owned by FWB's brother, James "Jimmy" Bramblett ("Jimmy"). Jimmy suggested they obtain financing from FKNB." (App. D, pp. 77a-78a)
- "Worth Sallee met with Logsdon who thought Sallee's purchase [of the convenience store] was a good idea. Logsdon obtained approval of the $100,000 loan based upon the Sallees' net worth of $211,870 as of June 5, 1988 (see attached Exhibit "C" and secured the loan with a mortgage on the Sallees' house, Worth Sallee's profit sharing plan, and the store inventory and equipment." (App. D, p. 78a)

III. FKNB Aware of Problems

- "In February of 1989, they [Office of the Comptroller of the Currency] had an exit interview with the FKNB board of directors and were critical of FKNB's loan practices. Based upon this examination, DFC initiated its own loan review in April of 1989. Significantly Logsdon had advance knowledge when DFC loan review was to make its inspection of DFC loan portfolio." (App. D, pp. 83a)

IV. FKNB Defrauds Sallee on Laundromat and ESOP

- "Shortly after the $142,000 [March, 1989] Laundromat loan was made, FWB approached Worth Sallee

about purchasing the Laundromat, which was located near the Sallees' convenience store. ***Shortly thereafter, Cooney contacted Sallee to discuss the debt on the Laundromat and FKNB's possible financing of Sallees' acquisition of the business." (App. D, p. 85a)

- "The Court finds that Cooney was instrumental in convincing Worth Sallee to purchase the Laundromat and that Worth Sallee reasonably relied upon the pro forma and site survey provided by FWB, in making his decision to purchase." (App. D, p. 86a)
- "It is important to note that during this entire process of loan negotiations that FKNB never revealed to the Sallees that the appraised value of the Laundromat had risen from $486,000 in February of 1988, to $647,000 in March of 1989 to its current high of $726,000 as of May 26, 1989, an average monthly increase in value of $17,135.34, or 3.65%, from its initial appraised value. This Court finds that this series of appraisals are, bluntly put, fraudulent, with the values being determined by FKNB loan formula rather than any economic factors." (App. D, pp. 87a-88a)
- "On May 31, 1989, the sale of the Laundromat and Sallee's loans closed. ***Second, the Sallees were presented with one of the strangest agreements this Court has ever reviewed (see attached exhibit E) which states that the Sallees will leave $100,000 from Worth Sallee's ESOP plan with FKNB in the form of either an IRA or a certificate of deposit until the Sallee loans were paid in full and further granted the bank "setoff rights" against the $100,000 ("Stock Agreement"). Sallee was granted the option to choose the form the $100,000 would take and the evidence clearly shows that he chose to deposit the $100,000 in an IRA." (App. D, p. 88a)

- "...Logsdon assured Sallees that he would put together a more comprehensive refinancing package. This package loan although never set forth in full detail, would have refinanced all of the Sallees' commercial debt into a single loan through FKNB." (App. D, p. 91a)
- "We find, based upon all the evidence, that Worth Sallee reasonably relied upon Logsdon's and Cooney's promises of a package loan in his dealing with FKNB." (App. D, p. 92a)
- "Throughout the late Summer and early Fall of 1989 Logsdon worked feverishly to keep Sallee, FWB and other related loans from becoming delinquent. As part of these efforts Logsdon convinced Sallee to sell his Lowes ESOP stock to help pay off a short term loan. Sallee only agreed to this course of action when Logsdon agreed to replenish Sallee's IRA (into which the Lowes stock was going to be placed) with funds from the promised package loan. Unfortunately for Sallee, Logsdon never established or even attempted to establish Sallee's IRA and ultimately, Sallee's retirement funds were lost." (App. D, pp. 102a-103a)
- "Here, under the extreme facts of this case, we find that Sallee placed misguided, but reasonable, faith and confidence in FKNB through Cooney and Logsdon during the entire course of the Laundromat transaction and the other FKNB loans made to the Sallees thereafter." (App. D, pp. 105a-106a)
- "Here, FKNB failed to disclose four major sets of material facts "effecting the loan" to the Sallees by failing to:
  - "(1) disclose to the Sallees the appraisal history of the Laundromat;"
  - "(2) inform the Sallees that this Laundromat was being sold as part of a workout program for the financially troubled Brambletts;"

"(3) clearly tell the Sallees that Worth Sallee's ESOP stock, or any proceeds thereof, would never be placed in an IRA, but would be held by FKNB as collateral for the Sallee loan;" and

"(4) make full and accurate disclosures about FKNB's actual intent and ability to refinance the short-term Sallee loan." (App. D, pp. 107a-108a)

- ". . . [W]e find that in addition to violating its fiduciary duty to the Sallees, as discussed above, FKNB also defrauded the Sallees by:

"(1) providing the Sallees with the misleading pro forma and site survey . . .; and"

"(2) misrepresenting the fact that FKNB was taking a security interest in Worth Sallee's ESOP stock, and the proceeds thereof, rather than placing the stock in an IRA as Logsdon had agreed to do for Worth Sallee." (App. D, pp. 108a-109a)

- "This Court finds, as a matter of fact, based upon its review of the facts and testimony of the Sallees, that had FKNB not induced the Sallees to purchase the loan or made their other false and fraudulent representations concerning the Sallees' Lowes ESOP stock, that the Sallee would have (and could have) sold the convenience store for about what they had in the business and paid off their debts without touching the Lowes ESOP stock. Further, we find that, but for the misrepresentations made by FKNB through Logsdon, the Sallees would have properly placed their Lowes ESOP stock into a self-directed IRA and left it there to grow in value.*** This Court finds that a properly established IRA, created through a valid rollover of the ESOP stock would have existed but for the fraud of Logsdon, Cooney and FKNB. Based upon the foregoing, we shall by separate order award the bankruptcy estate $1,170,000 as compensation for the lost ESOP stock." (App. D, pp. 115a-116a)

REASONS FOR GRANTING THE WRIT

The petition should be granted for two reasons. First, the decision of the Sixth Circuit so ignores the law of Kentucky, which was the substantive law to be applied, as to call for the exercise of this Court's supervisory power. The panel of the Sixth Circuit, all Ohio judges, ignored the substantive law of Kentucky as it had been construed by the Bankruptcy Court and District Court.

Second, the decision of the Sixth Circuit, in holding that the establishment of an IRA does not create a fiduciary relationship, conflicts with the decision of the Seventh Circuit Court of Appeals in *Masi v. Ford City Bank & Trust Company*, 779 F.2d 397 (7th Cir. 1985) and a decision of the Kentucky Court of Appeals rendered after the submission of briefs in this case.

I. The Decision of the Sixth Circuit Deviates From the Usual Standards of Appellate Review by Ignoring the Substantive Law of Kentucky.

Although this matter was tried in the federal system, the claims were governed by the substantive law of Kentucky. Applying that law, the Bankruptcy Court found that the Bank had defrauded the Sallees with respect to two separate aspects of the transaction: (1) the Bank defrauded the Sallees with regard to the value of the Laundromat; and (2) the Bank defrauded the Sallees with regard to the establishment of an IRA. The Bankruptcy Court Judge, a Kentucky practitioner experienced in and familiar with the nuances and directions of the Kentucky courts, also found as fact that the Bank had abandoned all pretext of being merely a commercial lender and had become the fiduciary of the Sallees. Although she modified the amount of damages related to the Laundromat, the District Court Judge, also an experienced Kentucky practitioner, affirmed the Bankruptcy Court's finding with respect to fraud and fiduciary duties. The panel of the Sixth

Circuit, while finding that the Sallees had in fact been defrauded with respect to the establishment of an IRA, deprived them of the separate damages related to that fraud and thereby ignored Kentucky law. Moreover, the panel ignored the developing law of Kentucky on fiduciary relationships and reversed the Bankruptcy Court with respect to that finding. The decision of the panel of the Sixth Circuit so deviates from the customary appellate review as to call for an exercise of this Court's supervisory powers by the granting of the writ.

A. Kentucky Law Mandates Damages for Every Wrong.

A fundamental precept of Kentucky law is that damages are to be recovered for every wrong. *USACO Coal Co. v. Liberty National Bank & Trust Co.*, 700 S.W.2d. 69 (Ky. App. 1985); *Western Union Telegraph Co. v. Guard*, 283 Ky. 187, 139 S.W.2d 722 (1940). It is implicitly, if not expressly, required by the Kentucky Constitution, § 14.

The Bankruptcy Court clearly found that the Sallees had been defrauded in two ways: (1) providing the Sallees with misleading pro forma and site survey information, while Cooney and Logsdon knew, or should have known, that Banet's appraisals of the Laundromat were inflated; and (2) misrepresenting the fact the Bank intended to place Sallee's ESOP in an IRA. Having found that there was a separate fraud with respect to ESOP, the Bankruptcy Court found that the loss of the value of the stock were the damages that flowed from that misrepresentation. At the time of trial, that stock was worth $1,170,000. Under Kentucky law, the Sallees were entitled to recover those damages.

In its Opinion, the Sixth Circuit recognized that a separate fraud had been perpetrated on the Sallees regarding the ESOP:

> Beyond finding fraud in Cooney and Logsdon's failure to mention the other appraisals, the Bankruptcy Court

found fraud in their representations regarding the treatment of Worth Sallee's ESOP stock. The Bankruptcy Court found the Sallees exercised ordinary care in relying on these representations.

The record supports the Bankruptcy Court's finding. The Bankruptcy Court found that: "both Logsdon and Cooney repeatedly assured Worth Sallee that his retirement would be safe and that his ESOP stock, or later the proceeds of it, would be placed in an IRA. (Bankruptcy Court Judgment at 55). Additionally, Worth Sallee testified that Logsdon and Cooney told him the placement of ESOP stock with FKNB was simply a requirement that he consolidate all his banking business with FKNB. FKNB sold the ESOP stock partially to repay one of Sallees' loans and never attempted to replenish the IRA. (App. B, pp. 27a-28a)

Despite this finding, clearly upholding the Bankruptcy Court's Judgment for the value of the stock, the Sixth Circuit deprived the Sallees and their estate of that value as damages.

In addition to the general precept that damages flow from every wrong, Kentucky follows the *Restatement (Second) of Torts*, § 549. See *Sanders, Inc. v. Chesmotel Lodge, Inc.*, 300 S.W.2d 239 (Ky. 1957). The *Restatement of Torts (Second)*, § 549, states:

1. The recipient of the fraudulent misrepresentation is entitled to recover damages in an action of deceit against the maker of the pecuniary loss to him of which the misrepresentation is a legal cause, including (a) the difference between the value of what he has received in the transaction and its purchase price or other value given for it; and (b) pecuniary loss suffered otherwise as a consequence of the recipient's reliance upon the misrepresentation.
2. The recipient of a fraudulent misrepresentation in a business transaction is also entitled to recover

> additional damages sufficient to give him the benefit of his contract with the maker, if these damages are proved with reasonable certainty.

The *Restatement* permits cumulative damages. Nevertheless, the Sixth Circuit erroneously believed that because of the doctrine of election of remedies, the Sallees could recover only the damages related to the value of the Laundromat, not the additional damages for the loss of their ESOP.

The Sixth Circuit mistakenly applied the doctrine of election of remedies. As it is applied in Kentucky, "this doctrine is, in general, directed to the selection and pursuit of one of two or more inconsistent or co-existent remedies available to a party thereby precluding himself from later resorting to another of the remedies [citations omitted]. The election is between remedies as distinguished from alternative substantive rights." *Northeast Coal Co. v. Blevins*, 277 S.W.2d 45, 48 (Ky., 1955). The election of remedies was never intended to destroy substantive rights such as the right to damages.

In fraud cases the election is between rescission and the resultant restoration of the status quo or affirmance and the pursuit of damages. The appropriate measure of damages is "such damages ... as will compensate him for the loss or injury actually sustained and *place him in the same position that he would have occupied had he not been defrauded.*" *Sanford Construction Co. v. S&H Contractors, Inc.*, 443 S.W.2d 227, 239 (Ky., 1969), quoting 37 *Am. Jur.* 2d 458 *Fraud and Deceit, §342* [emphasis added]. The Kentucky position on damages is the same as the *Restatement of Torts*, 2d, § 549, *supra*.

If the Sallees had elected to disaffirm the contract, title to the Laundromat would have been transferred to Bramblett, the loan proceeds repaid to the Bank, and the Sallees' note would have been marked paid and returned.

The ESOP stock, which was to have been placed in an IRA, would not have been affected.

The Sallees, however, affirmed the contract. That entitled the Sallees to all damages flowing from the fraud. Because they affirmed the contract, the Bank's claim based on that note was in fact a claim allowed in the Sallees' bankruptcy.

The distinction that the Sixth Circuit makes between a fraudulent misrepresentation and fraud in the inducement is erroneous. The Sallees were entitled to all of their damages which would have restored them to the position they would have had had they not been defrauded. *Sanford Construction Co.*, 443 S.W.2d at 239. Since they were separately defrauded as to how the ESOP stock was to be handled, they would have also been entitled to damages resulting from that separate fraud.

In her concurrence, Judge Batchelder correctly distinguished between fraudulent misrepresentation and fraudulent inducement. Had the Sallees elected to rescind the ESOP transaction, and chosen to not have an IRA in FKNB, the Bank would have returned to them the 5,999 shares of Lowes stock which represented the ESOP. The end result from that would be no different than that granted by the Bankruptcy Court when it awarded damages in an amount equal to that number of shares of stock. Either by rescission or by affirmance, the Sallees should have been entitled to their ESOP stock, either as a part of an IRA at FKNB or, presumably, at any other institution they chose. The Sixth Circuit's decision denied them that fundamental right under Kentucky law and precluded them from recovering damages related to the lost value of their ESOP.

In dicta, the Sixth Circuit indicated that even had they not held as they did on the election of remedies, they would have denied Sallee damages flowing from the loss of his ESOP based upon their construction of Section 402(c) of

the I.R.C. (26 U.S.C. 402(c)). That dicta was based upon the Bank's argument that the Sallees signed documents containing words of "assignment" and, therefore, destroyed their legal ability to rollover their ESOP into an IRA.

The Bankruptcy Court clearly found that the Sallees did not intend to grant a security interest in their ESOP to either Hardin County Bank [another creditor of Sallee on the convenience store] or FKNB. However, because of the possibility that by signing a "assignment" the Sallees triggered taxable consequences, the Bankruptcy Court rejected a separate claim of the Sallees to recover damages from those tax losses. Whether the distribution of the ESOP was taxable or not, however, does not negate the fact that the Sallees were deprived of the ESOP by virtue of the separate fraud of the Bank that it would create an IRA from it for the Sallees.

Even if the Sallees had destroyed their legal ability to rollover the ESOP into an IRA, that does not equate to the loss of the stock. It only requires that taxes be paid. They were. The tax treatment of the stock proceeds is a red herring. Even if the ESOP had not been rolled into an IRA but had been retained by the Bank, the Sallees would have retained ownership in the shares. They were deprived of that ownership by the fraud perpetrated by the Bank to gain control of the stock and to use it as collateral, instead of rolling it into an IRA.

When the Sixth Circuit affirmed the Bankruptcy Court's finding that the Sallees were defrauded in the establishment of an IRA, it denied them damages flowing from that fraud. The Sixth Circuit denied the Sallees a fundamental right under the substantive law of Kentucky.

B. Kentucky Law Provides That a Bank May Become a Fiduciary When Its Lending Is Coupled With Other Services.

During the trial and appeal of this matter, Kentucky law was controlled by the seminal holding of *Steelvest, Inc. v. Scansteel Service Center*, 807 S.W.2d 476 (Ky. 1991). The allegations in *Steelvest* were that the bank had assisted a new borrower, created by former officers of an existing borrower, with information from that existing borrower. The Kentucky Supreme Court recognized that under the traditional view, the relationship between a bank and its borrower was a debtor-creditor relationship, not one ordinarily imposing a fiduciary duty. Nevertheless, the Court held:

> However, services to borrowers and pledgors may support a finding that a bank, in taking a borrower's note and collateral, falls under a fiduciary duty to disclose material facts effecting the loan transaction. In view of changes in the nature of commercial transactions, bankers may sometimes be placed in a position of trust with respect to their customer.

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Thus, Kentucky law recognized that the commercial banking was changing and that services in addition to lending could create a fiduciary duty. The Kentucky Supreme Court realized that because of those changes, the circumstances could be so varied that it was impossible to create a comprehensive definition of when the relationship existed. That determination had to be left to the finder of fact.

Applying the *Steelvest* standard, the Bankruptcy Court, as trier of fact, found that FKNB stepped across the traditional line, engendered extraordinary trust, and coupled with the service of providing security for the Sallees' pension, became its fiduciary:

> Here, under the extreme facts of this case we find that Sallee placed misguided, but reasonable, faith and confidence in FKNB through Cooney and Logsdon during the entire course of the Laundromat transaction and the other FKNB loans made to the Sallees thereafter. Cooney and Logsdon did not merely respond to the Sallees' loan request but actively assisted Sallee in arranging the purchase of the Laundromat. Cooney represented to Sallee that paying off FKNB's debt was FWB's [Fred W. Bramblett] primary concern and that therefore he could work with FKNB, as opposed to FWB, whom he greatly distrusted in arranging the details of the sale. FKNB also presented Sallee with documents from loan files on the previous Laundromat loans purporting to be evidence of its value, *repeatedly assured Sallee that his pension assets were safe,* negotiated financing for Sallee with third-party lenders and promised additional financing to permit Sallee to consolidate his loans. In fact, Logsdon and Cooney did everything they could to lull Sallee into a false sense of security concerning his relationship with FKNB and induce him to both purchase the Laundromat, *blindly entrust his pension assets to FKNB* and continue to go deeper in debt in an effort to keep his hopeless loans from going into default. From the evidence presented in this case, both Logsdon and Cooney abandon any pretext of being merely creditors of Sallee when they actively assisted the Bramblett sale of the Laundromat to the Sallees, thereby riding FKNB of a bad loan to shaky borrowers while obtaining the Sallees' assets as collateral. See, *Steelvest*, 807 S.W.2d at 486. We, therefore, hold that the evidence that the evidence clearly and convincingly establishes that a fiduciary duty arose in this case between FKNB and the Sallees. [emphasis added] (App. D, pp. 105a-106a)

As the trier of fact, the Bankruptcy Court had the opportunity to hear the testimony directly and view the witnesses and determine their credibility. Following 38 days of such

testimony, he was clearly convinced that under Kentucky law the Bank had abandoned the mere pretext of being a creditor and had become the Sallees' fiduciary. His holding was clearly based in part upon the fact that the Bank had represented that it would protect the Sallees' pension assets as part of the transaction.

In its analysis of the fiduciary relationship, the Sixth Circuit relied upon the case law of Texas and Ohio. In rejecting the Bankruptcy Court's finding of the fiduciary relationship as clearly erroneous, the Sixth Circuit completely ignored the fact that the establishment of an IRA was an integral part of the relationship. The Sixth Circuit ignored that fact even though it held that the Bankruptcy Court correctly found the Bank defrauded the Sallees regarding the treatment of the ESOP.

After briefs were submitted in this case, the Kentucky Court of Appeals, following the transition begun in *Steelvest*, decided *Morton v. Bank of Bluegrass & Trust*, 18 S.W.2d, (Ky. Ct. App. 2000) (rehearing denied, review denied). The Mortons, as loan customers of the bank, purchased credit insurance related to that loan. When one of the Mortons was subsequently diagnosed with cancer, the bank refused to reissue the insurance policy in his name. The Kentucky Court of Appeals held that the borrowing of money, coupled with the purchase of insurance to cover the loan, created a sufficient level of trust and confidence to establish a fiduciary relationship. The court then held that the loan officer was under a fiduciary duty to disclose material facts related to the issuance of the insurance policy.

The facts in *Morton* are clearly analogous to those in Sallee. In both instances, the bank offered services in addition to or as a part of the loan. In *Morton*, the bank offered credit insurance to assure payment of its loan. In Sallee, the bank offered to establish an IRA to protect the Sallees' pension assets. In *Morton*, the bank failed to dis-

close the terms for reissuance of the policy. In *Sallee*, the bank failed to disclose that it was not establishing an IRA, but was rather taking the pension assets as collateral. The holding in *Morton* clearly reflects the evolution of Kentucky law in holding a bank to be a fiduciary when it offers services in addition to but connected with the making of a loan. The Sixth Circuit failed to recognize this distinction in Kentucky law and rather chose to apply the law of Ohio, the home state of the sitting panel.

The Sallees presented the Sixth Circuit with the holding and significance of *Morton v. Bank of Bluegrass & Trust*, 18 S.W.2d, in their petition for rehearing. That petition was summarily rejected. By so doing, the Sixth Circuit rejected both the substance and direction of Kentucky law.

II. The Opinion of the Sixth Circuit as it Relates to Fiduciary Duty Creates a Conflict of Decisions Within the Circuits.

The Sixth Circuit recognized that the Bank misrepresented to Sallee that he had to transfer his ESOP to it to be placed in an IRA. As quoted above, the Sixth Circuit found Sallee's reliance reasonable. The Sixth Circuit recognized that as a part of a lending transaction Sallee was required to consolidate his banking business with FKNB, including the establishment of an IRA. This was a "service" in addition to the loan. Despite these facts, the Sixth Circuit rejected the Bankruptcy Court's factual finding that a fiduciary relationship was established.

In *Masi v. Ford City Bank & Trust Co.*, 779 F.2d 397 (7th Cir. 1985), the Seventh Circuit reviewed the nature of a relationship between a bank and its depositor when an IRA was involved. The bank had setoff against an IRA amounts the depositor owed the bank on a guarantee. Relying on 26 U.S.C. § 408(a), the Seventh Circuit stated: "One must recognize that IRA's are not regular savings

accounts. They clearly are special deposits that constitute a trust relationship wherein the bank owes a fiduciary duty to the depositor." The rationale of the Seventh Circuit is consistent with Congressional intent in establishing tax deferred retirement vehicles as a part of the Internal Revenue Code. Moreover, it is consistent with the understanding and expectations of depositors.

IRA's are deemed by the general public to be special accounts. The income earned in an IRA is tax deferred. They are exempt from execution. The general belief is that they cannot be used as collateral. In fact, Ralph Mobley, an attorney and CPA for Sallee, testified that it was his understanding they simply could not be taken as collateral. It is not unreasonable to believe that when a bank holds an IRA, an individual's retirement future, it owes a special duty to that individual. The Seventh Circuit was correct in holding that the establishment of an IRA creates a fiduciary relationship.

The opinion of the Sixth Circuit in Sallee suggests that a bank owes no special duty when it takes funds or assets to establish an IRA. The Bankruptcy Court and the District Circuit found that the Bank had committed to establish an IRA for the Sallees. That commitment was memorialized by reference in the Agreement signed at closing. Despite this, the Sixth Circuit held that the Bank was not the Sallees' fiduciary. By so doing, it created an implied, if not explicit, conflict within the circuits.

CONCLUSION

This Petition presents this Court with a challenge to one of its fundamental assumptions. This Court has assumed that judges of the circuit courts were due deference when deciding cases under state law because they were more familiar with the substantive state law to be applied. That assumption is in error. In this case, three Ohio judges

of the Sixth Circuit reversed a factual finding and appellate decision by Kentucky judges, applying Kentucky law. In so doing, the Sixth Circuit ignored the developing case law of the Kentucky appellate courts and deprived the Sallees of a fundamental right to damages, a right guaranteed under Kentucky law. This decision so departs from acceptable bounds of appellate procedure as to call for this Court's exercise of its supervisory powers. Moreover, in holding that a bank's duty to establish an IRA does not create a fiduciary duty, the decision of the Sixth Circuit in this case conflicts with the appellate decision of the Seventh Circuit Court of Appeals and with the common understanding of depositors in this country. The decision of the Sixth Circuit is so contrary to law as to justify the granting of the Writ.

Respectfully submitted,

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Counsel For Appellees

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS

Case Nos. 00-5484/5652

In re: WORTH A. SALLEE,
SANDRA M. SALLEE,
JOHN WILSON, Trustee,
Appellees / Cross-Appellants

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versus

FORT KNOX NATIONAL BANK, N.A. and
DICKINSON FINANCIAL CORPORATION,
Appellants / Cross-Appellants

ORDER—Filed May 10, 2002

BEFORE: BATCHELDER, COLE, Circuit Judges and GWIN, District Judge*

Upon consideiation of the petition for rehearing filed by the appellees cross appellants,

It is ORDERED that the petition for rehearing be, and it hereby is, DENIED.

ENTERED BY ORDER OF THE COURT
/s/ Leonard Green
Leonard Green, Clerk

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*The Honorable James S. Owin, United States District Judge for the Northern District of Ohio, sitting by desination.

APPENDIX B

RECOMMENDED FOR FULL TEXT PUBLICATION
Pursuant to Sixth Circuit Rule 206
ELECTRONIC CITATION: 2002 FED App. 0128P (6th Cir.)
File Name: 02a0128p.06

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

Nos. 00-5484/5652

In re: WORTH A. SALLEE and
SANDRA M. SALLEE,

Debtors.

WORTH A. SALLEE, SANDRA M. SALLEE, and
JOHN WILSON, Trustee,

Plaintiffs-Appellees/
Cross-Appellants,

v.

FORT KNOX NATIONAL BANK, N.A. and
DICKINSON FINANCIAL CORPORATION,

Defendants-Appellants/
Cross-Appellees.

Appeal from the United States District Court
for the Western District of Kentucky at Louisville.
No. 98-00779—Jennifer B. Coffman, District Judge.

Argued: September 19, 2001

Decided and Filed: April 15, 2002

Before: BATCHELDER and COLE, Circuit Judges; GWIN, District Judge.

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*The Honorable James S. Gwin, United States District Judge for the Northern District of Ohio, sitting by designation.

COUNSEL

ARGUED: Philip W. Bledsoe, SHUGHART. THOMSON & KILROY, Kansas City, Missouri, for Appellants. Douglas G. Sharp, MORGAN & POTTINGER, Louisville, Kentucky, for Appellees. ON BRIEF: Philip W. Bledsoe, Richard M. Paul III, SHUGHART, THOMSON & KILROY, Kansas City, Missouri, Cathy S. Pike, Russell H. Saunders, WEBER & ROSE, Louisville, Kentucky, for Appellants. Douglas G. Sharp, John T. McGarvey, MORGAN & POTTINGER, Louisville, Kentucky, for Appellees.

GWIN, D. J., delivered the opinion of the court, in which COLE, J., joined. BATCHELDER, J. (pp. 42-44), delivered a separate opinion concurring in part and concurring in the judgment.

OPINION

GWIN, District Judge. With these appeals, we review the judgment of the U.S. Bankruptcy Court for the Western District of Kentucky. That court gave judgment of $3,009,998.25 against Appellant Fort Knox National Bank ("Fort Knox Bank") on Plaintiff Worth and Sandra Sallee's breach of a fiduciary relationship and fraud claims. This case arises from a complicated series of loans that the Sallees used to purchase and operate a convenience store and laundromat in the Fort Knox, Kentucky area. The case presents the unhappy collision between Fort Knox Bank's bad banking practices and the Sallees' business naivete and incompetence.

In wading through the morass created by Fort Knox Bank and the Sallees, we first describe the factual background upon which the Sallees base their claim of a fiduciary relationship with Fort Knox Bank. After considering this background, we find that Fort Knox Bank's relationship with the Sallees did not create a duty in Fort Knox Bank to act primarily in the Sallees' interest. The relationship between a bank and a borrower does not ordinarily impose a fiduciary duty upon the bank. While the Sallees may have been childlike in trusting Fort Knox Bank's rep-

resentatives, we find no reasonable person in their position would believe Fort Knox Bank acted on the Sallees' behalf in lending monies to the Sallees.

After discussing the Sallees' claim that Fort Knox Bank owed them a fiduciary duty, we examine the bankruptcy court's finding that the Sallees established their fraud claim. Regarding the fraud claim, Fort Knox Bank argues that the Sallees cannot show reasonable reliance unless they can establish their fiduciary claim. However, under Kentucky law, a duty to disclose may arise from a partial disclosure of information or from circumstances in which one party to a contract has superior knowledge and is expected to reveal it. We find that although Fort Knox Bank could refuse to give the Sallees the laundromat appraisals in its possession, it could not reveal one appraisal while keeping secret other appraisals that would show the appraiser had no idea of the laundromat's value.

Finding sufficient evidence to support the Sallees' fraud claim, we next examine Fort Knox Bank's argument that the Sallees released all claims against Fort Knox Bank by signing two Extension/Waiver Agreements ("extension agreement") in August and December 1989. The bankruptcy court found the extension agreement's release language insufficiently broad to prevent the Sallees' claims. Upon appeal, the district court found the release language broad enough to prevent the Sallees' claims. Nonetheless, the district court found Fort Knox Bank fraudulently procured the Sallees' assent to the extension agreement. Because we hold the evidence supports the district court's finding that Fort Knox Bank fraudulently induced the Sallees' execution of the release, we deny Fort Knox Bank's argument that the release prevents the Sallees' claims.

After finding that the Sallees have established their fraud claim, we turn to the bankruptcy court's determination of damages. In its judgment, the bankruptcy court awarded the Sallees damages for fraudulent misrepresentation and fraudulent inducement. We find that Kentucky

law required the Sallees to elect between a claim for fraudulent misrepresentation or one for fraudulent inducement. Because the Sallees elected to obtain damages for fraudulent misrepresentation, they could not obtain damages for fraudulent inducement. As a result, the bankruptcy court erred in awarding much of the damages found.

The bankruptcy and district courts found support for an award of punitive damages. We find sufficient evidence to support this finding. The bankruptcy and district courts calculated the punitive damage award as 75% of the compensatory damages. Because we find that the district and bankruptcy courts significantly overstate the compensatory damages, we affirm the district court's order to remand this case to the bankruptcy court to recalculate the punitive damage award.

I.

A. Procedural Background

Appellant Fort Knox Bank sued Appellees Worth and Sandra Sallee in the Circuit Court of Hardin County, Kentucky. In its complaint, Fort Knox Bank alleged the Sallees had defaulted on a $575,000 promissory note secured by a mortgage. Fort Knox Bank asked for judgment on the note with accrued interest. It also asked that the property securing the note be sold and the proceeds be applied against the loan.

The Sallees counterclaimed and then filed a petition for bankruptcy in the U.S. Bankruptcy Court for the Western District of Kentucky. The Sallees removed this lawsuit to bankruptcy court as an adversary proceeding related to a case under Title 11. *See* 28 U.S.C. § 1452 (2001). The Sallees then added a claim against third-party defendant/appellant Dickinson Financial Corporation ("Dickinson Financial"). Dickinson Financial was the corporate parent of Fort Knox Bank. The bankruptcy court had jurisdiction over this case under 28 U.S.C. §§ 157(b) and 1334(b) (2001).

After the bankruptcy court entered judgment against Fort Knox Bank, the appellants appealed to the district

court, which reviewed the decision of the bankruptcy court under 28 U.S.C. § 158(a) (2001). The district court reversed in part and affirmed in part the bankruptcy court's judgment. Appellants Fort Knox Bank and Dickinson Financial then appealed to this Court and the Sallees cross-appealed.

B. Factual Background

Because this factually complex case comes upon appeal from the record made at the bankruptcy court, we rely upon the bankruptcy court's factual findings.[1]

Appellant Fort Knox Bank was a small banking institution on and near the military post at Fort Knox, Kentucky. It offered unsophisticated banking services to military personnel and businesses in the surrounding community. At times relevant to this case, Dickinson Financial, a holding company, owned Fort Knox Bank.[2]

Fort Knox Bank primarily provided consumer banking services, with only a modest amount of commercial lending. This practice changed in the mid- to late-1980s. Like many other misguided lending institutions then, Fort Knox Bank decided to increase its commercial lending, which ultimately grew to approximately 40% of Fort Knox Bank's total loan portfolio.

Fort Knox Bank gave responsibility for commercial lending to Senior Loan Officer Ken Logsdon ("Logsdon") and Assistant Loan Officer Victoria Cooney ("Cooney"). Each possessed a dangerous combination of inexperience and incompetence.

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[1] The appellants do not directly challenge the factual findings of the bankruptcy court.

[2] Dickinson Financial sold Fort Knox Bank's assets to Golden Financial Corporation after Fort Knox Bank began this litigation. As part of the sale of these assets, Dickinson Financial agreed to indemnify Golden Financial Corporation for any judgments entered against Fort Knox Bank.

Displaying the "go-go" mentality that infected banking in the mid-1980s, Fort Knox Bank made a series of loans to Fred W. Bramblett ("Bramblett") and his family to finance a variety of real estate projects. Logsdon and Cooney authorized and supervised these loans.

The Bramblett family included Fred, Sr. and his wife Pearl, and their two sons, Fred W. and James Bramblett. They worked in the construction field and began borrowing large amounts from Fort Knox Bank in the mid-1970s. The Brambletts helped each other in their endeavors and routinely transferred property and loans between themselves.

Reflecting Logsdon and Cooney's incompetence, Fort Knox Bank poorly documented the loans made to Bramblett in the mid-1980's, loosely collateralized the loans, and made the loans with little financial information. Moreover, Fort Knox Bank continued this series of loans even though Bramblett's endeavors consistently lost money.

By the fall 1987, Fort Knox Bank's easy lending policy and Bramblett's incompetence resulted in Fort Knox Bank having several hundred thousand dollars of bad loans. Rather than face the consequences of his questionable lending practices, Senior Loan Officer Logsdon agreed to a generalized workout strategy with Bramblett. Under this workout strategy, Fort Knox Bank would give Bramblett, his businesses, and various family members and associates additional loans. Bramblett would use the new loans to keep his obligations to Fort Knox Bank afloat until Bramblett could divest the properties. Logsdon overstated the value of the collateral securing the original loans to allow him to lend Bramblett enough money to keep his old debts current.

Bramblett used the additional loans to keep past loans from going bad until he could turn his investments around or sell them. If necessary, Logsdon indicated that Fort Knox Bank would consider financing the purchase of one or more of Bramblett's properties, especially if the purchase could

be secured with better collateral than the security offered by the Brambletts.

Throughout 1989, Bramblett looked for persons to purchase the Brambletts' properties. When found, Senior Loan Officer Logsdon helped arrange financing for the purchases of the various properties.[3]

In putting together loan packages for the purchase of Bramblett's assets, Senior Loan Officer Logsdon and Bramblett often used appraiser David Banet. Banet's poor work struck the bankruptcy court. "[T]his Court notes that, except for other similar appraisals made by Banet for Fort Knox Bank, [the appraisal involved in this case] is the worst prepared appraisal it has had the opportunity to review in its past ten years on the bench." (Bankruptcy Court Judgment at 10). Importantly, Banet's appraisals disingenuously found real estate had the exact value needed to support whatever loan amount that Logsdon wanted.

Into this sorry mix stepped Worth and Sandra Sallee. Worth Sallee moved to Elizabethtown, Kentucky in 1974 after his employer, Lowe's, Inc. ("Lowe's"), promoted him. In 1980, Lowe's promoted Worth Sallee to store manager. While in this position he met the Brambletts, who made purchases at Lowe's.

Worth Sallee participated in an ESOP and profit-sharing plan while working at Lowe's. During his tenure with the company, he accumulated several thousand shares of Lowe's stock in these plans.

In 1988, Worth Sallee began looking for a business to purchase or operate after Lowe's transferred him to an Indiana store. During his search for a business to buy, Worth Sallee approached Jimmy Bramblett about a convenience store and car wash Jimmy built and was operating. After negotiating for a month or so, the Sallees agreed to purchase Jimmy Bramblett's convenience store for

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[3] Fred W. Bramblett, James Bramblett, their parents, and related entities all owned some of the assets.

$100,500.[4] In the agreement for the sale of the convenience store, the Sallees did not purchase the real estate. Instead, Jimmy Bramblett leased the real property to the Sallees for five years at $5,000 per month and granted the Sallees an option to purchase the real estate for $550,000.

After they agreed on the purchase, Jimmy Bramblett suggested to Worth Sallee that he obtain financing for the convenience store from Fort Knox Bank. Jimmy Bramblett then set up a meeting with Senior Loan Officer Logsdon to try to secure funding for the purchase. Worth Sallee had never done business with Logsdon before. Senior Loan Officer Logsdon agreed to have Fort Knox Bank lend the Sallees $100,000.[5] Although Logsdon and Worth Sallee discussed the assignment of Worth Sallee's pension fund to Fort Knox Bank as collateral, no assignment was made.

Shortly after purchasing the convenience store, the Sallees obtained a better loan from the Hardin County Bank & Trust Company ("Hardin County Bank"). In October 1988, the Hardin County Bank lent the Sallees $125,576. Hardin County Bank lent the money though the convenience store made little profit and the Sallees were having cash flow problems. The Sallees used the loan to pay off the Sallees' Fort Knox Bank loan.

The Sallees believed a security interest in the convenience store's assets and a second mortgage on the Sallees' home secured the Hardin County Bank loan. Beyond this security, the Sallees agreed to have Worth Sallee's profit-sharing plan stock "assigned" to Hardin County Bank. Worth Sallee's attempt to assign his stock to Hardin County Bank ultimately failed because he never delivered the stock certificates to Hardin County Bank.

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[4] The convenience store was titled to a related entity known as Bramblett Properties, Inc.

[5] Fort Knox Bank provided this money in two separate loans. On August 3, 1988, Fort Knox Bank loaned the Sallees $80,000. One week later, Fort Knox Bank loaned the Sallees $20,000.

During the fall 1988, the Sallees continued having cash flow problems with the convenience store. In December 1988, the Sallees obtained an additional working capital loan of $30,300 from Hardin County Bank. As collateral for the loan, the Sallees again attempted to grant a security interest in Worth's profit-sharing stock account to Hardin County Bank.[6] Apparently cautious as the result of the Sallees' failure to operate the convenience store at a profit, Hardin County Bank advised them that it would not give further loans. Hardin County Bank recommended the Sallees obtain financing for gasoline purchases from another bank.

Having tapped out their borrowing ability at Hardin County Bank, in January 1989, the Sallees returned to Fort Knox Bank for financing for gasoline purchases. Assistant Loan Officer Cooney supervised their application. On January 24, 1989, Fort Knox Bank lent the Sallees $50,000 for the purchase of gasoline. Again, Worth Sallee secured this loan through a purported security interest in his ESOP and profit-sharing plan stock.

While the Sallees unsuccessfully ran their convenience store, the Bramblett family tried to unload other assets securing their loans with Fort Knox Bank. As part of this plan, Fred W. Bramblett approached the Sallees and offered to sell them the laundromat next to the Sallees' convenience store.

Jimmy Bramblett had originally owned the laundromat. However, on February 25, 1988, his parents purchased the laundromat so he would not default on a loan to Fort Knox Bank. The Bramblett parents purchased the laundromat for $375,200. To make the purchase, Fort Knox Bank lent the Bramblett parents the entire $375,200. To justify such

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[6] The demand note purported to grant a security interest only in the profit sharing account stock but the assignment executed by the Sallees gives a security interest in both the ESOP and profit sharing account stock.

a loan, Fort Knox Bank used Banet's one-page appraisal of the laundromat property that said its market value was $469,000.

The Brambletts' poor business practices continued, and the Bramblett parents returned to Fort Knox Bank a year later for another loan on the laundromat. Fort Knox Bank lent them an additional $142,000. Although the Bramblett parents described the loan as intended for working capital, the Bramblett parents used all but $39,000 of the loan to pay Fred W. Bramblett's debt service and bank fees on other loans with Fort Knox Bank.

Fort Knox Bank justified the additional loan with a new appraisal by Banet. On the new appraisal, Banet valued the laundromat property at $647,000. Fort Knox Bank knew Banet increased the appraised value of the laundromat 38% in little more than one year. Banet raised the appraised value even though the Bramblett parents made no improvements to the property, were not making any significant money on the laundromat, and could not service the laundromat debt from its income.

It was at this time that Fred W. Bramblett approached Worth Sallee and offered to sell him the laundromat. The laundromat's game room attracted people Worth Sallee believed detracted from his adjacent convenience store. Worth Sallee became interested in buying the laundromat if he could replace the game room with washing equipment as a way to get rid of this undesirable traffic.

Both the Brambletts and Fort Knox Bank wanted to sell the laundromat. A sale to the Sallees would help the bank by closing a nonperforming Bramblett loan that was most likely undersecured. Equally important, the Sallees could offer security for their loan, a striking contrast to the Brambletts. Furthermore, if the Sallees believed the $647,000 appraisal, Fort Knox Bank and the Brambletts could receive an additional benefit of selling the laundromat for more than it was worth. If they sold the laundromat for more than it was worth, the Brambletts and Fort Knox would both benefit because of the Brambletts' reduced overall level of borrowing.

After Worth Sallee told Fred W. Bramblett that he might be interested in purchasing the laundromat, Fort Knox Bank vigorously pushed the sale. Assistant Loan Officer Cooney and Senior Loan Officer Logsdon approached the Sallees about financing their purchase of the laundromat. Logsdon assured Worth Sallee he was getting a good deal, that Fort Knox Bank would provide 100% financing, and that the Sallees would likely receive easy credit on future business loans.

In encouraging the Sallees to buy the laundromat, Bank Officers Cooney and Logsdon represented that Fort Knox Bank controlled the Brambletts and that the Sallees were purchasing the laundromat from the Bank.[7] To foster the sale, Fort Knox Bank showed the Sallees a pro-forma and site survey. Assistant Loan Officer Cooney represented to Worth Sallee that these documents were taken from Fort Knox Bank's files on the Brambletts.

Cooney and Logsdon gave the pro-forma and site survey to the Sallees as evidence of the laundromat's potential profitability. The pro-forma and site survey suggested the laundromat would gross between $152,000 and $200,585 per year. Worth Sallee testified that Cooney called him on

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[7] Worth Sallee testified:

> Q. ... Can you tell me why you're talking to the bank and what the bank said, if anything, about that?
>
> A. Oh, okay. I'm sorry. Vickie [Conlon] represented to me that she was in control of Freddie [Bramblett]. Freddie was apparently in some financial difficulty. And she told me that.
>
> * * *
>
> Q. How did you think you were going to buy the laundromat from him [Jimmy Bramblett] without getting involved?
>
> A. I wasn't buying anything from him. Vicki clearly told me that I would be dealing with the hank. And that I would be buying this from the bank.

(Joint Appendix at 856-57).

May 30, 1988, before the closing, and said an appraiser had appraised the laundromat for $750,000. (Joint Appendix at 871).

Importantly, Cooney and Logsdon never revealed to the Sallees that the laundromat's appraised value rose from $469,000 in February 1988, to $647,000 in March 1989, and then to $726,000 in May 1989. Banet did all three appraisals.[8]

On May 31, 1989, the Sallees purchased the laundromat. Based on Banet's final appraisal, Fort Knox Bank lent the Sallees $575,000 to purchase the laundromat.[9] To secure this loan, the Sallees gave Fort Knox Bank a mortgage on the laundromat and Worth Sallee assigned his ESOP retirement plan stock to Fort Knox Bank.

The Sallees' $575,000 note was a ninety-day term note. Although the note had a ninety-day term, Logsdon and Cooney told the Sallees that Fort Knox Bank would make them a long-term "package" commercial loan so they could consolidate all of their outstanding loans.

In April 1989, while the above events were unfolding, Dickinson Financial began reviewing Fort Knox Bank's loan portfolio. As a result of this highly critical review of Fort Knox Bank's commercial lending practices, Dickinson Financial stopped all commercial lending by Fort Knox Bank on December 18, 1989.

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[8]After reviewing this series of appraisals, the bankruptcy court found "that this series of appraisals are, bluntly put, fraudulent, with the values being determined by Fort Knox Bank loan formula rather than any economic factors." (Bankruptcy Court Judgment at 25-26).

[9] Fort Knox Bank was not alone in misrepresenting the value of assets. When Worth Sallee applied for the laundromat loan he gave Fort Knox Bank a financial statement showing a net worth of $319,739. The bankruptcy court found Worth Sallee overstated his net worth by over $50,000.

The Sallees soon began losing money on the laundromat and could not service their excessive debt. The Sallees sought an extension of their $575,000 note from Fort Knox Bank. In August 1989, Fort Knox Bank extended the note for an additional ninety days. On December 29, 1989, Fort Knox Bank agreed to a forty-eight-day extension of the repayment dates.

In exchange for each extension, the Sallees signed an extension agreement. These extension agreements released Fort Knox Bank from "any and all rights, claims, or causes of action with respect to the Loan Documents and Collateral." Additionally, Logsdon and Cooney told the Sallees Fort Knox Bank would still provide them with a "package" loan.

In September 1989, Hardin County Bank learned Worth Sallee had also pledged his ESOP stock to Fort Knox Bank as security for the laundromat loan. Hardin County Bank demanded the Sallees payback their loan or provide additional security. Hardin County Bank threatened the Sallees with legal action if its demand was not met. Logsdon arranged a short term $50,000 loan to pay back Hardin County Bank. Fort Knox Bank made the loan and Worth Sallee consented to having some of his ESOP stock sold to repay the $50,000 loan. Worth Sallee testified that he consented to the sale of his ESOP stock because he believed Fort Knox Bank would replenish his IRA when it gave him the "package" loan. Fort Knox Bank never replenished Worth Sallee's IRA.

When the Sallees signed the December 29, 1989, extension agreement, Senior Loan Officer Logsdon failed to tell them that Fort Knox Bank no longer provided commercial loans. Logsdon apparently hoped he would recover the ability to make commercial loans. Logsdon's hope ended in early January 1990 when Fort Knox Bank justifiably fired him and Cooney.

After January 1990, Dickinson Financial began to work through Fort Knox Bank's troubled commercial loans. Unfortunately for the Sallees, their massive laundromat debt made restructuring their finances impossible.

On October 17, 1990, Fort Knox Bank sued the Sallees in the Circuit Court of Hardin County, Kentucky seeking to foreclose on the property securing the $575,000 loan. The state court appointed a receiver to manage the laundromat and apply the profits to the mortgage indebtedness. Shortly thereafter, the Sallees filed a counterclaim against Fort Knox Bank, alleging, among other things, fraud in the inducement relative to the purchase of the laundromat and breach of the contract for financing the laundromat purchase. The Sallees then filed a petition for bankruptcy. The Hardin County action was removed to the bankruptcy court as an adversary action.

Before trial, Fort Knox Bank moved the bankruptcy court for summary judgment. In its motion for summary judgment, Fort Knox Bank argued that the extension agreement released Fort Knox Bank from liability on the Sallees' claims. The bankruptcy court denied the motion, holding that the phrase "any and all rights, claims, or causes of action with respect to the loan documents and collateral" was not broad enough to cover any of the Sallees' claims.

The trial lasted for thirty-eight days. On September 15, 1998, the bankruptcy court entered judgment in favor of the Sallees. The bankruptcy court found Fort Knox Bank owed a fiduciary duty to the Sallees and breached that duty by failing to reveal material facts concerning the loan. The bankruptcy court also found that Fort Knox Bank defrauded the Sallees by misrepresenting the value of the laundromat. Finally, the bankruptcy court found Fort Knox Bank defrauded Worth Sallee by leading him to believe that his ESOP stock taken as collateral was in an IRA. The court rejected the Sallees' other claims. The bankruptcy court absolved Dickinson Financial of any liability.

The bankruptcy court awarded the Sallees compensatory damages of $1,719,999. In finding compensatory damages of $1,719,999, the bankruptcy court awarded damages of $549,999 for the difference between the actual sale price of the laundromat and the price at a later U.S. Marshal's sale. The bankruptcy court also awarded dam-

ages of $1,170,000 for the value at trial of Worth Sallee's ESOP stock Fort Knox Bank used as collateral.

Finally, the bankruptcy court awarded punitive damages against Fort Knox Bank of $1,289,999.25. In awarding punitive damages, the bankruptcy court held that "punitive damages, in the amount of 75% of the above awarded compensatory damages . . . are appropriate." (Bankruptcy Court Judgment at 70). In total, the bankruptcy court gave judgment against Fort Knox Bank in the amount of $3,009,998.25.

Fort Knox Bank and Dickinson Financial appealed to the district court. In its Memorandum Opinion and Order, the district court reversed the bankruptcy court's measure of damages, ordered a corresponding reduction in punitive damages, and affirmed the remainder of the judgment.

II. Discussion

With their appeals, Fort Knox Bank and Dickinson Financial say the bankruptcy and district courts erred in several regards. First, they argue the courts erred in holding that the release in the extension agreement did not preclude the Sallees' claims. Second, they argue the courts erred in concluding that Fort Knox Rank owed a fiduciary duty to the Sallees. Third, the appellants say Fort Knox Bank is not liable for fraud because the Sallees could not prove reasonable reliance without a fiduciary duty. Fourth, they contend the bankruptcy court erred in determining damages. Finally, the appellants say the bankruptcy court should not have awarded punitive damages. The Court reviews these arguments.

A. Standard of Review

With regard to Fort Knox Bank and Dickinson Financial's appeals, "[w]hether an appeal comes to our court by way of a district court or the [bankruptcy appellate panel], our review is of the bankruptcy court's decision." *Koenig Sporting Goods v. Morse Rd. Co. (In re Koenig Sporting Goods, Inc.),* 203 F.3d 986, 988 (6th Cir. 2000) (quoting *Corzin v. Fordu (In re Fordu),* 201 F.3d 693, 696 n.1 (6th

Cir. 1999)). As before the district court, a bankruptcy court's conclusions of law are reviewed de novo. *Unsecured Creditors' Comm. of Highland Superstores, Inc. v. Strobeck Real Estate, Inc. (In re Highland Superstores, Inc.),* 154 F.3d 573, 576 (6th Cir. 1998). The Court accords discretion to the original bankruptcy court's findings but not to those rendered by the district court. *XL/Datacomp, Inc. v. Wilson (In re Omegas Group, Inc.),* 16 F.3d 1443, 1447 (6th Cir. 1994). We are just as capable of interpreting the record as the district Court. *Id.*

B. Breach of Fiduciary Relationship Claim

Before dealing with the Sallees' claim that Fort Knox Bank breached a fiduciary duty, we discuss the nature of a fiduciary relationship and the showing required to establish such a relationship.

A fiduciary relationship creates the highest order of duty imposed by law. If a fiduciary relationship exists, the fiduciary cannot profit from the relationship without the knowledge and permission of the principal. *See, e.g.,* Roy Ryden Anderson, *The Wolf at the Campfire: Understanding Confidential Relationships, 53* SMU L. Rev. 315, 317 (2000). In a fiduciary relationship, the fiduciary must make every effort to avoid having his own interests conflict with those of the principal. *See id.* When conflict is unavoidable, the fiduciary must place the interests of the principal above his own. *See id.*

A fiduciary duty requires more than the generalized business obligation of good faith and fair dealing. The Texas Supreme Court described this distinction in *Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp.,* 823 S.W.2d 591 (Tex. 1992):

> The duty of good faith and fair dealing merely requires the parties to "deal fairly" with one another and does not encompass the often more onerous burden that requires a party to place the interest of the other party before his own, often attributed to a fiduciary duty.
>
> . . . .

> The fact that one businessman trusts another, and relies upon his promise to perform a contract, does not rise to a confidential relationship. Every contract includes an element of confidence and trust that each party will faithfully perform his obligation under the contract. Neither is the fact that the relationship has been a cordial one, of long duration, evidence of a confidential relationship.

823 S.W.2d at 594-95 (internal citations omitted), *superseded by* Tex. Rev. Civ. Stat. Ann. art. 4413, § 6.06(e) (Vernon 2001) (establishing a duty of good faith and fair dealing between parties to a car dealership franchise agreement).

To make out a claim that a fiduciary relationship existed, the party claiming the fiduciary relationship must first show the relationship existed before the transaction that is the subject of the action. *See* Anderson, *supra,* at 324. Second, the party claiming a fiduciary relationship must show that reliance was not merely subjective. *See id.* Third, the party claiming a fiduciary relationship must show that the nature of the relationship imposed a duty upon the fiduciary to act in the principal's interest, even if such action were to the detriment of the fiduciary. *See id.*

As to the second requirement, the party seeking to have a fiduciary relationship recognized must show more than mere subjective trust. *See id.* at 327. An aggrieved party must also show that he trusted the other party to act as a fiduciary and that such trust was reasonable under the circumstances.[10] Only in rare commercial cases is it reasonable to believe the other party will put your interests ahead of their own.

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[10] Commentator Roy Anderson describes the distinction: "[I]t is one thing to trust someone to deal honestly and quite another to trust someone to put one's interests above his own. Extraordinary facts are necessary to make this latter kind of trust plausible and reasonable." Anderson, *The Wolf at the Campfire: Understanding Confidential Relationships,* 53 SMU L. Rev. 315, 320 (2000).

The *Crim Truck & Tractor* decision exemplifies the need for more than simple trust to create a fiduciary relationship. In *Crim Truck & Tractor,* a franchisee claimed his franchisor violated a fiduciary obligation owed to the franchisee when it canceled a forty-year franchise relationship. Although recognizing the parties to the franchise relationship had a long relationship founded upon confidence, the Texas Supreme Court found that no fiduciary obligation to act on the other's behalf was present. *See Crim Truck & Tractor,* 823 S.W.2d at 595-96 (quoting *Thigpen v. Locke,* 363 S.W.2d 247, 253 (Tex. 1962) (" '[M]ere subjective trust alone is not enough to transform arms-length dealing into a fiduciary relationship.' "))[11]

In deciding whether Fort Knox Bank owed the Sallees a fiduciary duty, we look to Kentucky law. While Kentucky has spoken less frequently on the creation of a fiduciary duty, it follows the guidelines described above.

Under Kentucky law, a fiduciary relationship is "founded on trust or confidence reposed by one person in the integrity and fidelity of another and which also necessarily involves an undertaking in which a duty is created in one person *to act primarily for another's benefit* in matters connected with such undertaking." *Steelvest, Inc. v. Scansteel Serv. Ctr., Inc.,* 807 S.W.2d 476,485 (Ky. 1991) (emphasis added).

In *Steelvest,* the Kentucky Supreme Court described a fiduciary relationship:

> The relation[ship] may exist under a variety of circumstances; it exists in all cases where there has been a special confidence reposed in one who in equity and

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[11] The Texas Supreme Court's reasoning in *Crim Truck & Tractor* is even more persuasive in the light of the Texas Legislature's decision to create a duty of good faith and fair dealing between parties to a car dealership franchise agreement. *See* Tex. Rev. Civ. St. Ann. art. 4413, § 6.06(e) (Vernon 2001).

> good conscience is bound to act in good faith and *with due regard to the interests of the one reposing confidence.*

Id. (quoting *Sec. Trust Co. v. Wilson,* 210 S.W.2d 336, 338 (Ky. 1948)) (emphasis added); *see also Lappas v. Barker,* 375 S.W.2d 248, 251 (Ky. 1963) (stating a fiduciary relationship exists "where a special confidence is reposed in another who .. is bound to act. . . with regard to the interests of the one reposing confidence").

Except in special circumstances, a bank does not have a fiduciary relationship with its borrowers. "' [T]he great weight of authority is that while the relationship between a mortgagor and mortgagee is often described as one of trust, technically it is not of a fiduciary character.'" *Forsythe v. BancBoston Mortgage Corp.,* 135 F.3d 1069, 1077 (6th Cir. 1997) (alteration in original) (quoting *Lovell v. W. Nat'l Life Ins. Co.,* 754 S.W.2d 298, 303 (Tex. Ct. App. 1988)) (interpreting Kentucky law to require an express contractual provision to create a fiduciary duty between a mortgagor and mortgagee) (citations omitted): *see also Steelvest,* 807 S.W.2d at 485 ("Courts traditionally view a relationship between a bank and a depositor to be one of debtor-creditor and do not ordinarily impose a fiduciary duty of disclosure upon the bank.").

Kentucky courts have twice imposed a fiduciary duty in the relationship between a bank and a borrower. On both occasions, the bank profited at the borrower's expense from confidential information received from the borrower. In *Steelvest,* the bank used the confidential business plans of one borrower to help one of the borrower's competitors generate new business for the bank. *See* 807 S.W.2d at 485-86.

Similarly, in *Henkin, Inc. v. Berea Bank & Trust Co.,* 566 S.W.2d 420 (Ky. Ct. App. 1978), the bank usurped a corporate opportunity of one of its borrowers that the borrower revealed to the bank in confidence. The bank used the opportunity for its benefit and to the borrower's detriment. *Henkin,* 566 S.W.2d at 422; *see also Bale v. Mam-*

moth Cave Prod. Credit Ass'n, 652 S.W.2d 851,854 (Ky. 1983) (noting that *Henkin* stands for the proposition that a bank's fiduciary duty arises from "confidential relations with its customers").

As described above, banks do not generally have fiduciary relationships with their debtors. This flows from the nature of the creditor-debtor relationship. As a matter of business, banks seek to maximize their earnings by charging interest rates or fees as high as the market will allow. Banks seek as much security for their loans as they can obtain. In contrast, debtors hope to pay the lowest possible interest rate and fee charges and give as little security as possible. Without a great deal more, a mere confidence that a bank will act fairly does not create a fiduciary relationship obligating the bank to act in the borrower's interest ahead of its own interest.

Fiduciary relationships arise when circumstances and the relationship of the parties show the parties understood and agree that confidence is reposed by one party and trust accepted by the other. Fiduciary relationships can be informal, but they must evidence circumstances showing both parties agreed that one party would be acting in the interest of the other.

We are unaware of any Kentucky case discussing whether a bank violates a fiduciary relationship when the bank refuses to extend additional credit to the customer. We find, however, that the Ohio Supreme Court's discussion of this issue in *Ed Schory & Sons, Inc. v. Society Nat'l Bank,* 75 Ohio St. 3d 441, 662 N.E.2d 1074 (1996), describes the general rule.

In *Schory,* a business alleged that a bank had breached a fiduciary relationship when the bank failed to offer additional loans to a long-time customer. The business customer alleged that he had relied upon the bank's representation that it would extend financing for additional phases of a construction project.

Although the bank had given the business customer advice and assistance in creating the construction develop-

ment, the court found this insufficient to create a fiduciary relationship. *Schory,* 75 Ohio St. 3d at 443, 662 N.E.2d at 1082. In reaching its decision, the *Schory* court first looked at the extent of the creditor and debtor relationship:

> The term "fiduciary relationship" has been defined by this court as a relationship "in which special confidence and trust is reposed in the integrity and fidelity of another and there is a resulting position of superiority or influence, acquired by virtue of this special trust."
>
> . . . .
>
> "The relationship of debtor and creditor without more is not a fiduciary relationship. A fiduciary relationship may be created out of an informal relationship, but this is done only when both parties understand that a special trust or confidence has been reposed."

75 Ohio St. 3d at 442,662 N.E.2d at 1081 (quoting *Umbaugh Pole Bldg. Co. v. Scott,* 58 Ohio St. 2d 282, 286, 390 N.E.2d 320, 323 (1979)) (internal citations omitted).

The *Schory* court concluded that advice in a commercial context does not create a fiduciary relationship:

> ". . . But here the offering and giving of advice was insufficient to create a fiduciary relationship. While the advice was given in a congenial atmosphere and in a sincere effort to help the [plaintiffs] prosper, nevertheless, the advice was given by an institutional lender in a commercial context in which the parties dealt at arms length, each protecting his own interest."
>
> [A]dvice given by a creditor to a debtor in a commercial context in which the parties deal at arm's length, each protecting his or her respective interests, is insufficient to create a fiduciary relationship.

75 Ohio St. 3d at 443,662 N.E.2d at 1082 (quoting *Umbaugh,* 58 Ohio St. 2d at 287, 390 N.E.2d at 323).

We find the Sallees fail to show they had a fiduciary relationship with Fort Knox Bank. They had no long-standing relationship with Fort Knox Bank. The Sallees only

approached Fort Knox Bank at Fred W. Bramblett's suggestion when they tried to put together financing for the purchase of the convenience store. After obtaining the loan for the purchase of the convenience store, the Sallees quickly went to Hardin County Bank to obtain additional financing.

More important, the Sallees understood Fort Knox Bank's interest was aligned with that of the Brambletts' and obviously at odds with the Sal lees' interest. The Sallees knew Fort Knox Bank controlled the sale of the laundromat because the Brambletts had unpaid loans secured by the laundromat.[12] The bankruptcy court found that Cooney told Sallee paying off Fort Knox Bank's debt was Fred W. Bramblett's primary concern.[13] The Sallees knew the bank was substituting the Sallees' obligation, secured by collateral, for the bad debt of the Brambletts. In such circumstances, no reasonable person could believe Fort Knox Bank aligned its interest with the Sallees to the extent it would put the Sallees interest ahead of its own.

Also, the Sallees themselves describe having only a generalized trust in Fort Knox Bank. Worth Sallee had trust and confidence in everyone he first met.[14] For example, Worth Sallee had the same level of trust, confidence and

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[12] The bankruptcy court found that "[d]uring these meetings [Assistant Loan Officer] Cooney informed Sallee that the bank was eager to get Fred Bramblett out of the Laundromat, and that Sallee could purchase the Laundromat from Fred Bramblett at a good price and that Fort Knox Bank would fully finance the transaction." (Bankruptcy Court Judgment at 22).

[13] In addition, Worth Sallee testified that "Vicki [Cooney] told me she controlled Freddie Bramblett. He was going to do whatever she told him to do." (Joint Appendix at 998).

[14] Worth Sallee testified, "I trust everybody when I first meet them," (Joint Appendix at 993), and "I have a lot of trust and confidence in most people I meet," (Joint Appendix at 1011).

reliance in the President of the Hardin County Bank as he had in Logsdon.[15]

A generalized trust in other businessmen and businesswomen cannot create a fiduciary relationship. Worth Sallee's unreasonable trust in Assistant Loan Officer Cooney and Senior Loan Officer Logsdon did not create a fiduciary relationship under which Fort Knox Bank has to sublimate its interest to the Sallees.

We find the bankruptcy court clearly erred when it found a fiduciary relationship between the Sallees and Fort Knox Bank. Principally, the bankruptcy court used the wrong standard in finding a fiduciary relationship had arisen. In addition, the bankruptcy court's finding of a fiduciary relationship was clearly erroneous given the position of the parties and the circumstances of the loan. Simply put, the bankruptcy court wrongly believed the Sallees' naive trust in bank officers, standing alone, created a fiduciary relationship.

C. Fraud Claims

Besides finding that Fort Knox Bank had broken a fiduciary duty to the Sallees, the bankruptcy court found that Fort Knox Bank and its employees defrauded the Sallees. The bankruptcy court found Fort Knox Bank defrauded the Sallees when it gave the Sallees the misleading pro-forma, site survey, and appraisals that Cooney and Logsdon knew, or should have known, were inflated. In

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[15] Worth Sallee testified:

Q. Now, you've told us, sir, that you trusted and relied on Mr. Logsdon and believed what he told you in June, July and August of 1988, although it was your first business contact with Mr. Logsdon. Did you have that same trust and reliance on Mr. Bateman [of Hardin County Bank] at the time you dealt with him in October of 1988?

A. Certainly.

(Joint Appendix at 980).

addition, the bankruptcy court found Fort Knox Bank defrauded the Sallees by misrepresenting the nature of the security interest it was taking in Worth Sallee's ESOP stock. The bankruptcy court, however, found that Fort Knox Bank did not defraud the Sallees concerning the promises of future financing.

With its appeal, Fort Knox Bank says the fraud claim cannot stand because the Sallees do not show reasonable reliance without a fiduciary duty. In response, the Sallees argue that the bankruptcy court's finding of fraud is supported even without finding a fiduciary relationship.

Under Kentucky law, a party making a fraud claim must prove six elements:

> The general rule is that to constitute actionable "fraud" it must appear: (1) That defendant made a material representation; (2) that it was false; (3) that when he made it he knew that it was false, or made it recklessly, without any knowledge of its truth, and as a positive assertion; (4) that he made it with the intention that it should be acted upon by plaintiff; (5) that plaintiff acted in reliance upon it; and (6) that he thereby suffered injury.

McGuffin v. Smith, 286 S.W. 884, 886 (Ky. 1926); *see also Moore, Owen, Thomas & Co. v. Coffey*, 992 F.2d 1439, 1444 (6th Cir. 1993).

The party asserting a fraud occurred has the burden of proving each element of the *McGuffin* test by clear and convincing evidence. *See Miller's Bottled Gas, Inc. v. Borg-Warner Corp.*, 955 F.2d 1043, 1051 (6th Cir. 1992).

Under Kentucky law, once a party chooses to make a representation, the party cannot keep secret information needed to make the representation accurate. Although mere silence is not fraudulent absent a duty to disclose, *Hall v. Carter*, 324 S.W.2d 410,412 (Ky. 1959), a duty to reveal may arise *from a partial disclosure of information*, or from particular circumstances such as where one party to a contract has superior knowledge and is relied upon to disclose that information. *Smith v. General Motors Corp.*, 979 S.W.2d 127, 129 (Ky. Ct. App. 1998).

More specifically, an early Kentucky court held that "[a] duty to speak may arise from partial disclosure; the speaker being under the duty of saying nothing, or to tell the whole truth." *Dennis v. Thomson,* 43 S.W.2d 18, 23 (Ky. 1931) (holding fraud existed because a company's prospectus did not reveal that the company was not producing the materials it implied).

In *Central States Stamping Co. v. Terminal Equip. Co.,* 727 F.2d 1405 (6th Cir. 1984), this Court used the reasoning of an English court in holding a bank sometimes had a duty to speak.

> In an English case which was similar to ours, *Hedley Byrne & Co., Ltd. v. Heller & Partners, Ltd.,* [1964] A.C. 465, 486, Lord Reid pointed out that a banker who receives an inquiry about the credit-worthiness of a customer has three courses open. *The banker can decline to give the information; he can give an answer with a clear qualification that it is given and accepted without any responsibility or is given without reflection or research; or, the banker can give an answer without qualification. Lord Reid concluded that if a banker adopts the third alternative he can be held to have accepted some responsibility for answering carefully or to have accepted a relationship with the inquirer which requires him to exercise such care as circumstances require.*
>
> *Hedley Byrne* was not a fraud case but involved a negligent answer by a banker. However, it dealt instructively with the duty to speak once a relationship is established in which the person questioned knows that the inquirer is relying on the fact that he, the person questioned, has superior information. The duty is particularly clear when the party answering the inquiry benefits directly from the actions of the inquiring party.

727 F.2d at 1409 (emphasis added).

Where one party to a contract knows the other relies on him to disclose all material facts, the duty rests on him not to conceal anything material to the bargain or assume

responsibility for damage caused by the concealment. *See Faulkner Drilling Co. v. Gross,* 943 S.W.2d 634,638 (Ky. Ct. App. 1997) (citing *Davis v. Comm'rs of Sewerage of City of Louisville,* 13 F. Supp. 672, 678 (W.D. Ky. 1936), *aff'd in part, rev'd in part,* 88 F.2d 797 (6th Cir. 1937)). Fraudulent concealment implies knowledge of the material fact concealed. *Fields v. Cornett,* 70 S.W.2d 954,958 (Ky. 1934). A material fact is a fact that affects the conduct of a reasonable person and is likely an inducement of the contract. *Faulkner,* 943 S.W.2d at 638.

In several meetings over a short period, Assistant Loan Officer Cooney gave Worth Sallee a pro forma, a site survey and an appraisal showing the value of the laundromat at $510,000.[16] In its commitment letter, Fort Knox Bank told the Sallees a mortgage would sufficiently secure their note given the laundromat's appraised value of $725,000. (Joint Appendix at 466). Cooney never revealed the February 1988 appraisal, showing a value of $469,000, nor the March 1989 appraisal, showing a value of $647,000.

These other appraisals had obvious importance. First, they show an extreme increase in the value of a floundering laundromat business without describing any justification for the increase. Second, and more important, disclosure of the other appraisals would have shown they were all done by the same appraiser, raising the question of the validity of the appraisals. Having shown the pro forma, the site survey, and one appraisal, Fort Knox Bank could not avoid revealing the other appraisals without making its earlier representations fraudulent.

Beyond finding fraud in Cooney and Logsdon's failure to mention the other appraisals, the bankruptcy court found fraud in their representations regarding the treatment of Worth Sallee's ESOP stock. The bankruptcy court found

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[16] The record does not identify the author of the $510,000 appraisal. However, Worth Sallee clearly based his decision to purchase the laundromat on the $510,000 appraisal. (Joint Appendix at 1001-03).

the Sallees exercised ordinary care in relying on these representations.

The record supports the bankruptcy court's finding. The bankruptcy court found that "both Logsdon and Cooney repeatedly assured Worth Sallee that his retirement would be safe and that his ESOP stock, or later the proceeds of it, would be placed in an IRA." (Bankruptcy Court Judgment at 55). Additionally, Worth Sallee testified that Logsdon and Cooney told him the placement of ESOP stock with Fort Knox Bank was simply a requirement that he consolidate all his banking business with Fort Knox Bank. Fort Knox Bank sold the ESOP stock to partially pay one [sic] the Sallees' loans and never attempted to replenish the IRA.

D. Extension Agreement's Waiver of the Sallees' Fraud Claims

On May 31, 1989, the Sallees gave a ninety day, $575,000 note to Fort Knox Bank. The note was given in anticipation that the Sallees and Fort Knox Bank would agree on a long-term "package" loan. Near August 29, 1989, Fort Knox Bank extended the loan for an additional ninety day period. On December 29, 1989, Fort Knox Bank extended the loan for a further forty-eight day period. In consideration of its agreement to extend the loan, Fort Knox Bank says the Sallees executed an extension agreement that released all claims against the bank.[17]

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[17]The extension agreement provided, in part:

> For the sole consideration of the extension of this debt . . ., the Borrowers . . . hereby waive, release, and forever discharge the Bank from and against any and all rights, claims, or causes of action with respect to the Loan Documents and Collateral which arise from any action or inaction by the Bank with respect to the Loan Documents and Collateral which occurred on or before the date of this agreement . . . . The Borrowers . . . further acknowledge and agree that the Bank is specifically relying upon the representations, warranties, and agreements contained in this paragraph, and that these representations, warranties, and agreements, constitute a material part of the consideration to the Bank without which the Bank would not consent to the extension of the debt permitted by this agreement.

(Joint Appendix at 593).

The bankruptcy court rejected Fort Knox Bank's argument that the Sallees had released their fraud claims when they executed the extension agreement. The bankruptcy court found the extension agreement was not broad enough to release or discharge the Sallees' claims because the waiver only dealt with claims with respect to the loan documents and collateral. The bankruptcy court then found Cooney and Logsdon's promise that Fort Knox Bank would provide them a "package" loan was not fraudulent.

Upon review, the district court found the extension agreement unenforceable because Fort Knox Bank obtained it through fraudulent misrepresentation. In its judgment, the district court found that the promise of a "package" loan had fraudulently caused the Sallees to execute the extension agreement.[18]

Upon appeal to this Court, Fort Knox Bank argues that under Kentucky law the language of the extension agreement is broad enough to release the Sallees' claims. Principally, Fort Knox Bank argues that we presume releases to include all claims unless the parties manifest an intent to exclude certain claims. *See Overberg v. Lusby,* 727 F. Supp. 1091, 1093 (E.D. Ky. 1990). Fort Knox Bank says the extension agreement did not express an intent to

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[18]The district court reconciled its holding with that of the bankruptcy court:

> On the issue of fraud the court does not discredit the Bankruptcy Court's factual findings or credibility determination. The Bankruptcy Court's determination that Cooney and Logsdon did not defraud the Sallees through their promises of future financing, however, is determinative of a separate legal issue, whether the failure to provide the Package Loan was itself fraudulent, not the issue here, whether the promise of the Package Loan was a misrepresentation made in order to fraudulently induce the Sallees to sign the release. Because the Bankruptcy Court's analysis of the release differed from this court's, the Bankruptcy Judge did not reach the instant issue.

(District Court Memorandum Opinion and Order at 23 n.6).

exclude the claims here. The Sallees do not challenge this argument. Instead, they argue fraud procured the extension agreement.

Under Kentucky law, like most jurisdictions, a release obtained by misrepresentation or fraud is unenforceable. *See Hooks v. Cornett, Lewis Coal Co.*, 86 S.W.2d 697, 699 (Ky. 1935); *see also Overburg*, 727 F. Supp. at 1094.

In soliciting the Sallees' execution of the waiver agreement with its release, Logsdon fraudulently induced the Sallees to sign the agreement. On December 18, 1989, Dickinson Financial ended all commercial lending at Fort Knox Bank, including renewals and extensions of existing loans. The bankruptcy court found, "[t]his action in effect ended any chance Logsdon had to make good on his (and Fort Knox Bank's) promise of the package loan. Logsdon did not inform . . . Sallee about this new policy." (Bankruptcy Court Judgment at 39).

Senior Loan Officer Logsdon's records support this interpretation. On December 29, 1989, Logsdon wrote a memo suggesting the Sallees' balance would be placed on monthly payments. The bankruptcy court found that Logsdon represented to the Sallees on December 29, 1989, that he would extend their debt until he could put together the "package" loan. The bankruptcy court also found that the Sallees signed the extension agreement because of Logsdon's representation concerning the "package" loan.

Accordingly, when the Sallees signed the extension agreement on December 29, 1989, Logsdon knew he did not have the power to complete his promise of an additional loan to the Sallees. As described above, when Logsdon made a representation regarding a future consolidation loan he created a duty to reveal the whole truth. *See Dennis*, 43 S.W.2d at 23.

Logsdon's representation that Fort Knox Bank would give a long term loan was critical in the Sallees' decision to sign the extension agreement. The Sallees' original note was for ninety days. In describing the original relationship

set up by Fort Knox Bank, the bank's commitment letter said the loan would involve a ninety-day construction note and a "20 year amortization w/ 2 year balloon." (Joint Appendix at 466). Given that the Sallees were borrowing the entire cost of the laundromat, the parties knew the Sallees would be unable to pay the ninety-day note at its term. The Sallees reasonably relied upon Senior Loan Officer Logsdon's representation that Fort Knox Bank would offer a consolidation loan.

Having found that Fort Knox Bank obtained the extension agreement through fraud, we reject Fort Knox Bank's argument that the extension agreement prevents the Sallees' claims.

E. Compensatory Damages

In its decision, the bankruptcy court awarded the Sallees three items of damages. First, it awarded the Sallees $549,999 in damages for the misrepresented value of the laundromat. It calculated those damages by subtracting the actual value of the laundromat at the time of the Sallees' purchase from the price as represented by Fort Knox Bank. As to its value at the time of sale, the bankruptcy court used the price at which the laundromat sold at a United States Marshall's sale four years later. Second, the bankruptcy court gave the Sallees damages for the lost value of the Sallees' ESOP stock, finding that but for the Bank's fraud, the Sallees would have had a properly established IRA. Third, the bankruptcy count awarded the Sallees punitive damages for Fort Knox Bank's fraudulent actions.

The district count found the bankruptcy court erred when it used the value at the Marshall's sale to set the value of the laundromat at the time the Sallees' purchased the laundromat. Instead, the district count held the value of the laundromat at the time of the sale should be $305,000, the value established by a reliable appraiser. The district court did not disturb the damages award for fraud regarding the ESOP stock. We now decide whether the bankruptcy court's computation of damages was proper.

1. Whether damages are available for fraudulent inducement

Fort Knox Bank says the Sallees, under Kentucky law, were required to elect whether they sought damages for fraudulent misrepresentation or for fraudulent inducement. Fort Knox Bank says the state court ordered such an election and the Sallees chose to seek damages for fraudulent misrepresentation, not fraudulent inducement. Because of this election, Fort Knox Bank says the bankruptcy court erred when it awarded the Sallees' damages for both fraudulent misrepresentation and fraudulent inducement. We understand Fort Knox Bank to argue that under Kentucky law, the remedies available to a party claiming to have been fraudulently induced to enter into a contract are mutually exclusive; the defrauded party may elect either to rescind the contract, return the benefits received and recover the consideration given, or to affirm the contract and recover damages for the fraud. The Sallees argue in their cross appeal that the bankruptcy court's award of damages is correct.

On October 17, 1990, Fort Knox Bank sued the Sallees in the Circuit Court of Hardin County, Kentucky. The bank sued upon the unpaid note and sought foreclosure of the property securing the $575,000 loan. Fort Knox Bank sought a receiver. In opposing the appointment of a receiver, the Sallees argued they had been fraudulently induced to agree to the contract providing for a receiver. The state court ordered the Sallees to elect whether it sought damages for fraudulent inducement or for fraudulent misrepresentations. Specifically, the state court observed:

> A correct interpretation of these principles leaves the Sallees with these options: (1) rescind the transactions by repaying or tendering the principal sum of money received from the Bank in exchange for the note, raising fraudulent inducement as an affirmative defense to any claim for accumulated interest and/or counterclaiming for any alleged damages; or (2) affirm the transactions and counterclaim for any damages caused by the alleged fraud. Manifestly, proof of

> fraudulent inducement does not permit them to simply keep the Bank's money.

Fort Knox Nat'l Bank v. Sallee, No. 90-CI-1440, at *3 (Hardin County Ct. Aug. 31, 1991).

The Sallees elected to keep the money. By electing to keep the bank's money, Fort Knox Bank says the Sallees gave up their right to seek damages for fraudulent inducement.

A party claiming fraudulent inducement must normally rescind the contract. Otherwise, the party is limited to recovering the difference in the value of the property as represented and its actual value. In *Moore, Owen, Thomas & Co.,* we described the Kentucky rule on fraudulent inducement damages:

> Under Kentucky law, "one claiming to have been defrauded into making a contract has an option either to disaffirm the contract and seek its rescission or to affirm the contract and seek his remedy by an action for damages; he may not follow inconsistent remedies. He has but one election, and if he affirms the contract, his election is irrevocable and he condones the fraud."

992 F.2d at 1445 (quoting *Hampton v. Suter,* 330 S.W.2d 402, 406 (Ky. 1959) (citations omitted)); *see also Patel v. Patel,* 706 S.W.2d 3,4 (Ky. Ct. App. 1986) (reiterating the rule that when fraud has been committed in obtaining a contract, a party can either affirm the contract and recover damages due to the fraud or rescind the contract).

Under Kentucky law, the Sallees "condone[d] the fraud" by affirming the contract. *Sanford Constr. Co., Inc. v. S&H Contractors, Inc.,* 443 S.W.2d 227, 236 (Ky. 1969) (citing *Hampton,* 330 S.W.2d at 406).

In granting Fort Knox Bank's motion to appoint a receiver, the state court told the Sallees they needed to rescind the loan and return the principal lent or affirm the contract and counterclaim for damages. On January 6, 1992, the Sallees filed their counterclaim.

The Sallees affirmed the laundromat loan transaction with full knowledge of the facts. This mandatory election allows them to sue for fraudulent misrepresentation, but not for fraudulent inducement. The Sallees are therefore precluded from seeking damages flowing from the inducement of the laundromat purchase.

2. Calculation of damages for fraudulent misrepresentation

Having found that the Sallees cannot recover damages for fraudulent inducement, we consider whether the bankruptcy court correctly determined the damages available for fraudulent misrepresentation. Under Kentucky law, the Sallees may recover the difference between the value of the property as it was fraudulently represented and the value of the property had it been properly represented. *See Dempsey v. Marshall,* 344 S.W.2d 606,607 (Ky. 1961). "In such cases, the measure is generally held to be the difference between the actual and represented value of the business or property." *Id.; see also* Restatement (Second) of Torts § 549 (1977).[19]

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[19]The Restatement (Second) of Torts § 549 states the general rule:

> (1) The recipient of a fraudulent misrepresentation is entitled to recover as damages in an action of deceit against the maker the pecuniary loss to him of which the misrepresentation is a legal cause, including
>
> (a) the difference between the value of what he has received in the transaction and its purchase price or other value given for it;

Under this section of the Restatement, additional damages could only be recovered (1) when the financial position of a third person is misrepresented for the purpose of inducing the recipient to extend credit to him, (2) when a buyer, in reliance upon the misrepresentation, uses the subject matter of the sale in the belief that it is appropriate for a use for which it is harmfully inappropriate, or (3) when he has incurred expenses in preparation for a use of the article for which it would have been appropriate if the representation had been true.

In their cross appeal from the district court's judgment, the Sallees say the bankruptcy count correctly calculated their damages by subtracting the laundromat's price at a United States Marshall's sale from the laundromat's value as represented by Fort Knox Bank.

The bankruptcy court awarded the Sallees $549,999 as damages for the purchase of the laundromat. The bankruptcy count determined this amount by finding the difference between the appraisal that Fort Knox Bank gave them and the value of the laundromat when sold at a United States Marshall sale four years later. The district count lowered the damage award by substituting the actual price of the laundromat at the time of the misrepresentation, as determined by an appraisal, for the price of the laundromat at the United States Marshall's sale.

The district court correctly held the bankruptcy court erred in its calculation. "The Bankruptcy Court's award of $549,999 was clearly erroneous as it not only gave the Sallees the benefit of their bargain but also compensated them for economic changes affecting the value of the laundromat, independent of the fraud." (District Court Memorandum Opinion and Order at 27). The proper damage award is $421,000, the difference between the laundromat's final appraised value and what it was actually worth on the day the Sallees purchased it.

3. Discussion of whether damages recoverable for lost stock appreciation

As discussed above, the Sallees declined the state court's opportunity to rescind its transaction with Fort Knox Bank and sue for damages arising from the Bank's fraudulent inducement. Having declined the opportunity to make a consequential damage claim, the Sallees are limited to damages representing the difference in the value of the laundromat as represented and its actual value. Because we find the bankruptcy court erred when it awarded damages for fraud in the inducement, we find the award of damages associated with the pledged Lowe's stock was error. Therefore, we do not reach the issue whether the dam-

ages from fraudulent inducement should include damages from the Sallees' loss of a favored tax treatment for the Lowe's stock. Nonetheless, we offer a few comments upon the question.

The bankruptcy count clearly erred when it gave any of the damages flowing from fraudulent inducement. The bankruptcy court also erred regarding the proper measurement of damages that would have been available even if the Sallees had retained their right to make claims for damages for fraudulent inducement.

The bankruptcy court held that "a properly established IRA, created through a valid rollover of the ESOP stock would have existed but for the fraud of Logsdon, Cooney and [Fort Knox Bank]." (Bankruptcy Count Judgment at 64). The bankruptcy court wrongly attributed liability for the loss of the tax-deferred status of the Sallees' ESOP to Fort Knox Bank.

As to whether the Sallees could recover the lost value of stock appreciation, Fort Knox Bank argues that the Sallees' cannot recover damages resulting from the lost appreciation of Worth Sallees' stock held in a tax-deferred account. Seeking to counter this argument, Worth Sallee makes the improbable argument that when he executed an assignment and directed Lowe's to give custody of his stock to Fort Knox Bank he did not intend to create a security interest in Fort Knox Bank.

Fort Knox Bank did not cause any loss of the tax-deferred status of Worth Sallee's ESOP. Before pledging the stock to Fort Knox Bank in the laundromat transaction, the Sallees had twice pledged the ESOP stock to the Hardin County Bank. Section 408 of Title 26 of the U.S. Code governs IRAs and requires that, except in the case of a rollover contribution to an IRA, the amount of money one may place in an IRA is limited under 26 U.S.C. § 219(b)(1)(A). Whether a rollover would have been valid in this case is governed by 26 U.S.C. § 402(c)(4).

Section 402(c), and its accompanying regulation, 26 C.F.R. § 1.402(c)-2,A-4(d), direct that an amount is not

eligible for rollover into an IRA if the amount is a "deemed distribution" under 26 U.S.C. § 72(p). Section 72(p) provides that a person who "assigns (or agrees to assign) . . . any portion of his interest" in an ESOP is deemed to have distributed that interest. 26 U.S.C. § 72(p). Here, the Sallees twice assigned or agreed to assign their interest in Worth's ESOP to Hardin County Bank. This destroyed, prior to any representations made by Fort Knox Bank, any ability the Sallees may have had to roll the ESOP into an IRA. Fort Knox Bank cannot be held liable for any loss the Sallees suffered as a result of the loss of tax-deferred status caused by the Sallees themselves.

As found by the bankruptcy court:

> In October of 1988, the Sallees obtained a new loan from the Hardin County Bank & Trust Co. in the amount of $125,576.00.... The Sallees also said they consented to have Worth's ESOP and Profit Sharing plan stock "assigned" to Hardin County. While this Court believes Worth Sallee's testimony that he did not intend to pledge his Lowes stock to Hardin County he did consent to an assignment of the stock to Hardin County, . . .

(Bankruptcy Court Judgment at 13-14).

Even if the effort to assign the stock to Hardin County Bank did not defeat the tax-deferred benefit, the later assignment and sale of some of the stock would end the tax-deferred status. The Sallees authorized their broker to sell 5,999 shares of Lowe's stock held by Worth Sallee in his retirement plan. As the result of this sale, they received more than $178,000.

After the brokerage firm mailed Sallees the proceeds, Worth Sallee endorsed the check and delivered it to Fort Knox Bank. Worth Sallee consented that at least $50,000 should be used to pay off a loan from Fort Knox Bank. The Sallees also agreed to use part of these proceeds to satisfy debts they owed to Hardin County Bank. They cannot plausibly claim they retained tax deferred status after voluntarily selling the stock and applying some of the proceeds to their business debts.

F. Punitive Damages

After trial, the bankruptcy court awarded punitive damages of $1,289,999.25 against Fort Knox Bank because of its fraud. The appellant says the punitive damages award should be set aside because Fort Knox Bank, the wrongdoer, no longer exists. As a provision of the contract selling Fort Knox Bank, Dickinson Financial agreed to pay any damages in this case. Appellants argue that the bankruptcy court should not award any punitive damages against Dickinson Financial given that the bankruptcy court absolved Dickinson Financial from all liability in the case.

The bankruptcy court awarded punitive damages under Kentucky Revised Statutes Annotated §§ 411.184(1)(f) & 411.184(2) (Banks-Baldwin 2001).

> (1) As used in this section and KRS 411.186, unless the context requires otherwise:
>
> . . . .
>
> (f) "Punitive damages" includes exemplary damages and means damages, other than compensatory and nominal damages, awarded against a person to punish and to discourage him and others from similar conduct in the future.
>
> . . . .
>
> (2) A plaintiff shall recover punitive damages only upon proving, by clear and convincing evidence, that the defendant from whom such damages are sought acted toward the plaintiff with oppression, fraud or malice.

Ky. Rev. Stat. Ann. §§ 411.184(1)(f) & 411.184(2).

The district court, in accepting the bankruptcy court's assessment of punitive damages, specifically rejected the argument that assessing damages has no deterrent effect because Dickinson Financial has sold Fort Knox Bank. Noting that Dickinson Financial controlled Fort Knox Bank, the district court questioned whether Dickinson Financial's inadequate supervision of Fort Knox Bank's lending practices had contributed to the damages.[20] Of greater impor-

[20]The bankruptcy court found that "other than their failure to more carefully monitor Fort Knox Bank, we can find little fault with the actions of Dickinson Financial and its owner." (Bankruptcy Court Judgment at 48).

tance, the district court found an assessment of punitive damages would "serve to deter other banks, both those still owned by Dickinson Financial and independent banks, from similar conduct, furthering the purpose of an award of punitive damages." (District Court Memorandum Opinion and Order at 30).

We agree that punitive damages should be awarded. Punitive damages have a twofold effect. They punish wrongdoers and deter others.

We find unpersuasive the appellant's argument that the bankruptcy court should not have levied punitive damages because Fort Knox Bank no longer exists. While the appellant cites cases where punitive damages were not assessed based on the idea that only a wrongdoer should pay such damages, they are factually distinguishable from this case. *See Barnes v. Smith*, 305 F.2d 228 (10th Cir. 1962) (no punitive damages against estate of a deceased wrongdoer); *Fahrenbacher v. Quackenbush*, 759 F. Supp. 1516 (D. Kan. 1991) (same); *Kentucky Central Ins. Co. v. Schneider*, 15 S.W.3d 373, 375-76 (Ky. 2000) (award of punitive damages overturned because underinsured motorist coverage definition of "bodily injury" does not cover punitive damages; dicta further says such an award is ludicrous as victim's insurance would have to pay).

In its sale of Fort Knox Bank to Golden Financial Corporation, Dickinson Financial agreed to indemnify Golden Financial for any judgment against Fort Knox Bank. Without this indemnification, Golden Financial would have born the punitive damages. Dickinson Financial became liable for the punitive damages only because it agreed to accept that risk in its contract with Golden Financial. By agreeing to indemnify this risk, Dickinson Financial received consideration from Golden Financial. Dickinson Financial either sold Fort Knox Bank at a higher price or completed a sale it would not otherwise have made. We see no reason to relieve Dickinson Financial of the risk it voluntarily assumed.[2]

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[2] Dickinson Financial sold Fort Knox Bank to Golden Financial for $1.7 million. In addition, it upstreamed $1.5 million of surplus capital.

Dickinson Financial continues to work in the financial field. An award of punitive damages will discourage Dickinson from allowing similar conduct at other locations. As important, punitive damages will discourage other similarly situated banks from engaging in like conduct.

However, because the bankruptcy court based its punitive damage award on 75% of the compensatory damages, we remand the case back to the bankruptcy count for a new determination of punitive damages.

III. Conclusion

The district court erred in finding Fort Knox Bank had a fiduciary relationship with the Sallees. The district court correctly held the Sallees' signing of the extension agreement did not waive their claims against Fort Knox Bank. The bankruptcy count correctly found for the Sallees on their fraud claim.

With respect to damages, the district court correctly recalculated the Sallees' compensatory damages on their fraudulent misrepresentation claim. The district court erred when it allowed damages for fraudulent inducement. The district court correctly allowed punitive damages but we remand the case hack to the bankruptcy court for a new determination of those damages.

The judgment of the United States District Court for the Western District of Kentucky in case 00-5484 and 00-5652 is **AFFIRMED** in part, **REVERSED** in part, and **REMANDED** to the United States Bankruptcy Court for the Western District of Kentucky.

CONCURRENCE

ALICE M. BATCHELDER, Circuit Judge, concurring in part and concurring in judgment. I concur in the judgment of the majority opinion. I write separately with regard to the majority's statement of Kentucky law relating to the election of remedies for fraudulent inducement.

Fort Knox Bank argues on appeal—erroneously, I believe—that the Sallees, under Kentucky law, were required

to elect whether they sought damages for fraudulent misrepresentation or fraudulent inducement. The majority opinion adopts the Bank's erroneous characterization of Kentucky law.

Fraud in the inducement requires misrepresentation. Black's Law Dictionary defines fraud in the inducement thus:

> Fraud connected with underlying transaction and not with the nature of the contract or document signed. Misrepresentation as to the terms, quality or other aspects of a contractual relation, venture or other transaction that leads a person to agree to enter into the transaction with a false impression or understanding of the risks, duties or obligations she has undertaken.

BLACK'S LAW DICTIONARY (6th ed. 1990). In Kentucky, when a party is *induced* by a fraudulent *misrepresentation* to enter into a contract, that party must elect to either: (1) "affirm the contract and recover damages in tort for the fraud;" or (2) "disaffirm the contract and recover the consideration with which he has parted." *H. C. Hanson v. Am. Nat'l Bank & Trust Co.*, 865 S.W.2d 302, 306 (Ky. 1993). The required election is not between a cause of action for fraudulent misrepresentation and one for fraudulent inducement. Rather, the election required is between the available remedies-either affirming the contract and claiming damages or rescinding the contract. *Sanford Constr. Co. v. S & H Contractors, Inc.*, 443 S.W.2d 227, 236 (Ky. 1969).

In this case, the Sallees claim that they were induced to purchase the laundromat by Fort Knox Bank's fraudulent representations. The Sallees' claim is one for fraudulent inducement. The election that Kentucky law requires them to make is the election of remedies-they may elect to affirm the contract and pursue damages, or they may elect to rescind the contract. The majority opinion says that since the Sallees "affirmed the laundromat loan transaction" they may sue only "for fraudulent misrepresentation,

but not for fraudulent inducement." This is an incorrect statement of Kentucky law. There is no issue here of fraudulent misrepresentation versus fraudulent inducement. Here, a fraudulent misrepresentation by Fort Knox Bank induced the Sallees to purchase the laundromat.

The proper distinction between fraudulent misrepresentation and inducement derives from the context in which the fraudulent misrepresentation occurred. If the misrepresentation occurred with the "intention of inducing" a party to act, the result is fraudulent inducement. If the misrepresentation did not occur within the context of inducing another to act, but instead was a misrepresentation for other purposes, the result is another form of fraud, for example, fraud in the factum, where the document signed was itself misrepresented.

I agree with the result reached by the majority. In its order granting Fort Knox Bank's motion to appoint a receiver, the state court explicitly told the Sal lees that they would have to make an election of remedies. The Sallees, however, have made no specific election, and it is undisputed that they have kept the money they borrowed from Fort Knox Bank. As a result, they have condoned the fraud by affirming the contract. *Terrill v. A.H. Carpenter,* 143 F. Supp. 747, 753 (E.D. Ky. 1956). Under Kentucky law, as found by the majority, the Sallees may recover the difference between the value of the property as it was fraudulently represented and the actual value of the property. *Dempsey v. Marshall,* 344 S.W.2d 606, 607 (Ky. 1961). But I do not join in the majority's confusion about what the damages thus calculated are to recompense. These damages are for fraudulent inducement. Because the Sallees elected to affirm the contract they were fraudulently induced to enter into, they are limited to damages measured by the difference between the actual and the misrepresented value.

Finally, I agree with the majority's determination that the bankruptcy court erred in awarding damages for the loss of the ESOP (although in light of the discussion of the

Sallees own culpability in destroying the tax-deferred status of their ESOP and the ultimate holding that the bankruptcy court erred in awarding damages for loss of the Lowe's stock, I am puzzled by the majority opinion's statement that the bankruptcy court's finding that the Sallees used ordinary care in relying on the Bank's representations regarding that stock is supported by the record). I agree as well that the Sallees could have elected to rescind that transaction-which was part of the larger laundromat transaction-but did not. That they thereby limited themselves to damages measured by the difference between the actual value of the laundromat and its misrepresented value, however, is not because they are not entitled to damages for fraudulent inducement. It is because in this action for fraudulent inducement, they elected to affirm the contract.

APPENDIX C

UNITED STATES DISTRICT COURT

WESTERN DISTRICT OF KENTUCKY

LOUISVILLE

Case No. 3:98CV-779-A

FORT KNOX NATIONAL BANK,
Plaintiff / Counter-Defendant / Appellant.

versus

WORTH A. SALLEE, and
SANDRA M. SALLEE,
Defendants / Counter-Plaintiffs / Appellees.

versus

DICKINSON FINANCIAL CORPORATION,
Third-Party Defendant / Appellant.

MEMORANDUM OPINION AND ORDER

—Entered March 22, 2000

This matter is before the court upon the appeal of Fort Knox National Bank ("FKNB") and Dickinson Financial Corporation ("DFC") from the judgment in the amount of $3,009,998.25 entered against it by the United States Bankruptcy Court at the close of a trial in an adversary proceeding on the counterclaim of Worth A. Sallee and Sandra M. Sallee ("Sallees"). The court has reviewed the arguments of counsel and affirms the Bankruptcy Court in part and reverses it in part and remands this case to that court for reduction of the actual and punitive damages in keeping with this order.

Statement of Jurisdiction

This court has appellate jurisdiction to review the decision of the bankruptcy court under 28 U.S.C. § 158(a) because this matter is an appeal of a final judgment of a bankruptcy court entered in a bankruptcy case under 28 U.S.C. § 157.

Procedural History

FKNB originally filed this suit against the Sallees in the Hardin Circuit Court. The Sallees counterclaimed and then filed for bankruptcy under Chapter 11 in the United States Bankruptcy Court for the Western District of Kentucky. The lawsuit was removed to the Bankruptcy Court under 28 U.S.C. § 1452 as an adversary proceeding related to a case under Title 11. The Sallees then added a claim against third-party defendant/appellant DFC. The Bankruptcy Court had jurisdiction in this case pursuant to 28 U.S.C. § 1334(b) and 11 U.S.C. § 157(b). On September 15, 1998, at the close of a 38-day trial, United States Bankruptcy Judge Henry H. Dickinson entered a memorandum opinion, order, and judgment in favor of the Sallees. FKNB filed this appeal on December 28, 1998, raising six issues of law for review.

Standard of Review

This court reviews the findings of fact of the Bankruptcy Court under the clearly erroneous standard and reviews the conclusions of law *de novo. In Re: Omegas Group, Inc.,* 16 F.3d 1433, 1447 (6th Cir. 1997). Here, the appellants do not challenge the Bankruptcy Court's findings of fact. However, as the parties' summaries vary, the court will summarize the facts below.

Factual Summary

This case stems from a series of ill-conceived commercial loans, involving FKNB, DFC, and the Sallees. FKNB, a small banking institution located on the military post of Fort Knox, Kentucky, offered a range of consumer banking services to Fort Knox military personnel and citizens of the surrounding community. In January of 1985 DFC, a holding company for a number of banks, acquired FKNB. Gary Dickinson was the majority owner of both FKNB and DFC. Both DFC and FKNB had focused primarily on consumer banking services with a modest amount of commercial lending. In the 1980s, however, FKNB increased its commercial lending to 40% of its total portfolio.

In 1983, Fred W. Bramblett ("FWB") entered real estate development, forming F.W. Bramblett Builders, Inc. ("BB Inc.") to build and sell single-family homes and duplexes. By 1985, FKNB had extended to BB Inc. a $250,000 line of credit, later increased to $425,000. That year BB Inc. also obtained additional loans to acquire Rose Realty. In late August of 1986, FWB formed Vertex Construction ("Vertex"), which apparently assumed some of the assets and business of BB Inc. This business restructuring resulted in a negative net worth for BB Inc., and by September of 1986, BB Inc. owed FKNB over $354,000.00. Nevertheless, FKNB renewed Vertex's line of credit on the apparent strength of the assets of Vertex and FWB. This series of loans and business transactions began a series of poorly documented, inadequately collateralized loans to FWB and the companies he controlled.

During the spring of 1987, FWB expanded his construction business, aided by FKNB and in particular its then Senior Vice President, Kenny Logsdon. In April of 1987 FKNB loaned $35,000.00 to FWB as operating capital for his real estate and construction business, and in May FKNB began to make individual construction loans to Vertex and Webco.[1] The initial three loans totaled approximately $139,000.00 and were never cross-collateralized. In May of 1987 Vertex began a commercial construction project for a Super 8 Motel, partially financed by a series of short-term notes and with loans diverted from other projects. The Bankruptcy Court found that FKNB had some knowledge of the diversion of the funds. FKNB never took an assignment of the project, but obtained assignments of small bits of the contract.

FWB began to experience significant financial difficulties by the Fall of 1987. On October 22, 1987, he refinanced $48,000.00 of debts based on creative financial information that FKNB neither verified nor seriously

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[1] Webco was another FWB-controlled entity.

reviewed. FKNB also increased FWB's line of credit to $250,000 and made an additional loan on October 30, 1997, collateralized with the right to receive money under a previous loan by FKNB to Vertex.

That winter, the foundation of FWB's construction and real estate empire began to crumble. The Super 8 contract collapsed after the parties for whom FWB was building the hotel refused to pay him due to dissatisfaction with his work. FKNB did not pursue its security interest in the hotel and, although Logsdon admitted the Bank was aware of FWB's financial problems, FKNB financed another project for the construction of homes In the Academy Heights subdivision in January of 1988.

In late January, FWB informed Logsdon that he was broke and was planning to file bankruptcy. They agreed to a generalized workout strategy which would entail FWB, his businesses, and various Bramblett family members and associates' obtaining more loans from FKNB to be used to keep his various loans afloat until FWB could either pay his obligations or sell his projects to satisfy his debt to FKNB. A further element of this workout was for FKNB to find new borrowers to purchase FWB's over-mortgaged properties and take over FWB's debt.

In April of 1988, FKNB loaned FWB $307,500.00 for the construction of a strip mall in Elizabethtown, Kentucky. The loan brought FWB's debt over FKNB's internal lending limits. The loan was supported by a dubious[2] appraisal by David Barnet, estimating the value of the completed center at $410,000.00. As FWB believed he could build the center for less than $250,000.00, a significant amount of the proceeds of the loan was diverted to pay debt service and FWB's various debts and to keep Vertex's checks from bouncing.

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[2]The Bankruptcy Court noted that the appraisal was the worst it had reviewed in the past ten years.

In September of 1988, Gary Smith, President of Pioneer Mortgage Co., a subsidiary of FKNB, contracted with FWB to purchase the shopping center. The purchase contract was made through Rose Realty and expired on October 30, 1988. Smith decided not to purchase the shopping center due to the poor construction and the amount of debt on the center. Almost three weeks after the Smith contract expired, however, FKNB loaned FWB an additional $102,500 on the shopping center project, secured by an assignment of the expired Smith contract. Meanwhile FWB struggled to survive and in late September, he sold his real estate in Academy Heights to Dick Booher and Pat Roush, who received their financing from FKNB. Through the financing of the deal, FWB diverted, with the knowledge and agreement of FKNB, over $30,000 from the first and second shopping-center loans, combined with the Roush loan proceeds, to pay off mechanic's liens and the mortgage on the Academy Heights property.

At this time, the Sallees began their lending relationship with FKNB when they sought to buy a convenience store owned by FWB's brother, Jimmy. After the Sallees discussed the purchase of the store with Logsdon, he approved a $100,000 loan based upon the Sallees' net worth of $211,870 for the purchase of the business and a lease of the real property at $5,000.00 a month with an option to purchase for $550,000.00. Sallee testified that Logsdon wanted to have Sallee's ESOP Stock Plan placed in FKNB but never discussed taking a security interest in the stock. Logsdon, however, fully intended to obtain the ESOP stock to secure the loan. On August 1, 1988, Worth Sallee executed a letter to Lowe's, his former employer, directing that all of his stock in his ESOP account be sent to FKNB when Sallee retired and the stock was distributed to him.

The store, however, proved to be not very profitable. In October of 1988, the Sallees obtained a new loan from the Hardin County Bank & Trust Co. ("Hardin County") in the amount of $125,576.00 to be used to pay off the FKNB loan. The loan was secured by a security interest in the

food-store assets and a second mortgage on the Sallees' home. The Sallees also said that they consented to have Worth's ESOP and Profit Sharing plan stock assigned to Hardin County, although Worth Sallee believed this meant that it would be placed in an IRA account and Hardin County would not take an interest in the stock. Based upon Worth's consent to an assignment of the ESOP and Profit Sharing stock, Hardin County attempted to take a security interest in the stock. This attempt failed because Hardin County never obtained possession of the stock and was prevented by ERISA from taking a security interest in the stock. The Bankruptcy Court found Sallee's understanding of the stock "assignment" to be indicative of his "total lack of any understanding of business or financial matters and his almost childlike trust in banks."

Throughout the fall of 1988, the Sallees continued to have cash flow problems with the convenience store and obtained an additional working-capital loan from Hardin County, attempting to grant a security interest in Worth's Profit Sharing stock. That bank suggested that, due to the Sallees' inability to generate any financial data for their business, they take their gasoline financing elsewhere. In January of 1989, the Sallees returned to FKNB, obtaining a loan for the purchase of gasoline inventory from FKNB loan officer Victoria Cooney. That loan was also secured by a purported security interest in the ESOP and Profit Sharing Plan stock. The granting of a security interest in such stock is invalid under ERISA and any attempt to do so has adverse tax consequences. Again, the Bankruptcy Court found that Sallee did not believe he was granting a security interest in the stock to FKNB.

Beginning in November 1988, the Office of the Controller of the Currency performed a safety-and-soundness examination of FKNB, and based upon that Office's critical evaluation, DFC initiated its own loan review in April of 1989. DFC, however, gave Logsdon advance knowledge before inspections were made. In March of 1989, FWB was able to sell his shopping center to Booher and to pay off

the initial shopping-center loan and obtain a note from Booher for $100,000, which was immediately pledged to FKNB as additional collateral. The same month, FKNB approved a loan to FWB to purchase the P&J Food Mart, although the record owners of the property were to be his parents. Later in March, FWB sold the property-management division of Rose Realty to one of its employees for $75,000.00. FKNB loaned the employee the money necessary for the purchase and took an assignment of the company's business contracts, estimated at $160,000.00.

In February of 1988 FWB's parents obtained a $375,000.00 loan to purchase a laundromat, secured by a first mortgage on the laundromat, which had been appraised at $469,000.00 by Barnet. Approximately one year later, FKNB made a $142,000.000 loan to FWB's parents to be used for working capital. However, all but $39,000.00 of the loan was used to pay FWB's debt service, to fund escrow accounts on FWB deals, and to pay bank fees. At the same time, Barnet reappraised the property at $647,000.00, a 38% increase over the previous year, an appraisal amount found to have stemmed from the amount needed for the loan rather than from economic reality.

Shortly thereafter, FWB approached the Sallees about purchasing the laundromat, which was located near the convenience store. FKNB's Cooney contacted Worth Sallee to discuss the debt on the laundromat and FKNB's possible financing of the purchase. She informed Sallee that the Bank was eager to get FWB out of the laundromat and that the Sallees could purchase it from FWB at a good price and FKNB would fully finance the transaction. She also gave Sallee a pro-forma and site survey concerning the laundromat.[3] The Bankruptcy Court concluded that the pro-forma and site survey were provided to Sallee as evidence of the potential profitability of the laundromat and

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[3] It is unclear whether the pro-forma was for the laundromat or another similar business.

to induce him to purchase the property. The documents indicated that the laundromat would gross between $152,000.00 and $200,585.00 per year. Cooney also discussed the possibility of making further loans to Sallee to consolidate his business debt and to permit him to purchase the convenience store real estate.

The FKNB Loan Committee approved a $575,000.00 loan to the Sallees on May 26, 1989 ("Sallee Loan"). The Sallees believed the amount of the Sallee Loan represented the entire purchase of the laundromat, based on a current Barnet appraisal of the laundromat of $726,000.00, the delivery of the current profit-and-loss statement on the business, and a pro-forma statement on the new business. During the entire process of loan negotiations, FKNB never revealed to the Sallees that the appraised value of the laundromat had risen from $469,000.00 in February of 1988 to $726,000.00 by May of 1989. The Bankruptcy Court determined that the series of appraisals by Barnet were

> fraudulent, with values determined by the FKNB loan formula rather any economic factors. Further, based on the quality of the appraisals and the math . . . Logsdon and Cooney deliberately ignored the clear evidence that the appraisals were inflated appraisals in their rush to keep FWB afloat by making new loans to FWB and other related parties and assisting him in obtaining new purchasers for his over appraised projects, such as the Laundromat.

The Bankruptcy Court further noted that Logsdon and Cooney knew that the Sallees were relying upon their representations in making their decision to purchase the laundromat.

On May 31, 1989, the sale of the laundromat and the Sallees' loans closed in an eventful closing. The loan agreements were confusing and ultimately ended with the Sallees pledging the proceeds of Worth's retirement plan, apparently without their knowledge. The loan agreement provided that the Sallees would leave $100,000 from Worth Sallee's ESOP plan with FKNB in the form of either an

IRA or certificate of deposit until the Sallee Loan was paid in full and would grant the Bank "set off rights" against the $100,000.00. Sallee chose to deposit the $100,000.00 in an IRA. The IRA, however, was never established. At the time of the closing, Cooney informed the Sallees that Worth's retirement account could not be touched by the Bank, and based on these assurances and a quick review of the agreement, the Sallees signed the document. The Bankruptcy Court concluded that the Sallees did not know they were pledging their retirement benefits, due to the obtuse loan documents and Cooney's misrepresentations. In July of 1989, Lowe's distributed Worth Sallee's ESOP stock, which was delivered to Cooney as of September 1, 1989. Cooney gave Worth Sallee a "safekeeping receipt" for the stock, but the receipt contained small, boiler-plate language that the distributed stock was also security for the gas inventory loan. The Bankruptcy Court, however, credited Sallee's testimony that the typewritten notation of the stock's being security for the gas inventory loan was not present when he executed the document.

The Sallees were then presented with a real estate purchase contract between themselves and FWB's parents, with the purchase price of $725,000.00 to be financed by the Sallees' loan of $575,000.00 and a $150,000.00 note payable from the Sallees to FWB. Cooney attempted to convince the Sallees that the price was inserted for bank purposes only. The Sallees refused to sign the note and attempted to delete all references to the note on the contract, but missed a reference on the first page of the contract.[4]

Cooney discussed the possibility of a loan package to consolidate the Sallees' commercial debt ("the Package Loan") during negotiations for the Sallee Loan and com-

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[4] After the contract was signed, Cooney had the money disbursed to the Bramblett parents' note to FKNB, freeing their credit for another loan of $669,600.00 for the purchase of apartments by FWB.

mitted to Worth Sallee that FKNB would at least provide long-term refinancing of the Sallee Loan, as the original loan was less than for one year.

After the laundromat closing, Worth Sallee informed Hardin County that he would be able to pay off his obligation to them as soon as FKNB put together the Package Loan. For the next several months, Logsdon and Worth Sallee often discussed the Package Loan. In August, Sallee informed FKNB that the final renovation of the laundromat was completed and inquired about the status of his Package Loan. FKNB argued that it never agreed to make a $1,200,000.00 commercial loan to the Sallee, but the Bankruptcy Court found that Logsdon and Conney orally promised Worth Sallee to make a Package Loan. As the Sallees continued to work with FKNB, Logsdon assured the Sallees that he would put together a more comprehensive refinancing package. Despite the Sallees' failure to make their August 29, 1989 interest payment, FKNB renewed their loans. Although FKNB had agreed to put the laundromat on long-term financing, the renewed loans were short-term loans.

Shortly thereafter, the Sallees began to have serious problems with their other lender, Hardin County, which had not received its ESOP stock because, unknown to that bank, it had been delivered to FKNB under the Sallees' agreement with FKNB for the Sallee Loan. Worth Sallee misled Hardin County by telling it to contact Lowes when, as of September 1, 1989, he knew the stock was with FKNB. On September 15, 1989, Hardin County learned of the location of the stock and sent Sallee a demand letter requiring him either to pay his loans or to provide a sufficient guarantee of such payment by September 19th or face legal action. Sallee met with Hardin County officers, who extended the deadline a few days, and then met with Logsdon and Conney. Logsdon told Sallee he would work with him to raise money to pay off Hardin County, although he was unable to complete the Package Loan. A $50,000.00 loan was approved as a short-term, unsecured

capital loan. Sallee was informed by Logsdon that his stock would be sold and Sallee consented to the sale of the stock, upon Logsdon's guarantee that Worth's IRA would be replenished when Logsdon closed the Package Loan. Logsdon failed to tell Sallee that no IRA had been set up for him at FKNB. After FKNB received the proceeds check, the Bank used $50,143.83 to pay off the $50,000.00 note owed by the Sallees and applied an additional $16,985.34 to interest on the Sallee Loan. The balance of the proceeds were used to purchase a certificate of deposit, which was held as collateral for the Sallee Loan, not placed in an IRA as had been represented to Worth Sallee by Logsdon.

At the same time Carroll Yates, a newly hired senior commercial lending officer, discovered some of the problematic FWB loans, including several faked transactions. Yates informed DFC of this fraud and began to refuse to renew or extend loans without the payment of current interest. DFC and Dickinson began to monitor FKNB's commercial lending activities more closely. Through the end of 1989, the Sallees continued to discuss the status of the Package Loan. Logsdon told Sallee that there were problems at the Bank, but that when he was made president he would be able to make the Package Loan in early 1990.[6]

On December 18, 1989, however, Dickinson and the FKNB board terminated all commercial loans made without DFC approval, including renewals or extensions of ex-

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[6] By the end of January 1990, Logsdon, Cooney, and Yates were fired and James Thompson, the DFC officer who "cleans up" problem loans, met with the Sallees. Their discussions continued for several weeks as he tried to glean information about the Sallee Loan and attempted to determine whether FKNB could legitimately refinance the Sallees' loan. Unfortunately for the Sallees, the massive amount of debt on the laundromat, coupled with the serious questions surrounding the entire laundromat transaction, made any restructuring of their finances impossible.

isting loans, ending any chance Logsdon had to make good on his and FKNB's promise of a Package Loan, Logsdon did not inform the Sallees of this new policy. On December 29, 1989, the Sallees entered into a 48-day extension of the laundromat loan. The Bankruptcy Court found that Worth Sallee signed the extension agreement based upon Logsdon's representation concerning the Package Loan. The extension agreement included a waiver and release of any claims arising from the loan or its collateral.

In this case, the Sallees complained that they were seriously damaged by FKNB's failure to make the Package Loan. The Bankruptcy Court found, however, that had the loan been made, its only effect would have been to increase the amount of debt the Sallees owed at the time of their bankruptcy. The court also found that while FKNB had breached its fiduciary duty and defrauded the Sallees in the laundromat and ESOP transactions, it did not defraud the Sallees concerning the promise of the new Package Loan because Logsdon believed he would be able to provide the loan at a later date when he first promised the Sallees the loan.

Legal Analysis

Existence of Fiduciary Relationship

The appellants argue that the Bankruptcy Court erred when it concluded that FKNB owed the Sallees a fiduciary duty. The appellants also argue that if FKNB held no fiduciary relationship with the Sallees, then it had no duty to disclose material facts and that the Sallees' reliance on the information presented by FKNB was not reasonable. After a *de novo* review of the issue, the court concludes that the Bankruptcy Court did not err in its conclusion that FKNB stood in a fiduciary relationship with the Sallees and that the Sallees reasonably relied on the Bank's disclosures.

A fiduciary relationship is founded upon "trust and confidence reposed by one person in the integrity and fidelity of another and which also necessarily involves an undertaking in which a duty is created in one person to act

primarily for another's benefit in matters connected with such undertaking." *Steelvest v. Scansteel Service Center, Inc.*, 807 S.W.2d 476, 485 (Ky. 1991). *See also Forsythe v. BancBoston Mortgage Corp.*, 135 F.3d 1069 (6th Cir. 1997). Under Kentucky law, the relationship between a bank and a depositor alone does not impose a fiduciary duty of disclosure upon the bank because the parties' relationship is merely one of a debtor to a creditor. *Steelvest v. Scansteel Service Center, Inc.*, 807 S.W.2d 476 (Ky. 1991). A fiduciary relationship may develop between a bank and borrower, however, creating an exception to this general rule.

> [S]ervices to borrowers and pledgors may support a finding that a bank, in taking a borrower's note and collateral, falls under a fiduciary duty to disclose material facts affecting the loan transaction. In view of changes in the nature of commercial transactions bankers may sometimes be placed in a position of trust with respect to their customers.

Steelvest, 807 S.W. 2d at 485. Indeed, "a bank can stand in a fiduciary capacity with respect to confidential relations with its customers." *Bale v. Mammoth Cave Production Credit Assoc.*, 652 S.W.2d 851, 854 (Ky. 1983).

If a bank stands in a fiduciary relationship to a borrower, that relationship gives rise to certain duties. As explained in *Steelvest*, the fiduciary duty of a bank taking a borrower's note and collateral requires it to disclose material facts affecting the loan transaction. This position of trust that may grow out of the bank-borrower relationship also gives rise to other duties. For example, "a bank official to whom an application for a loan is made must act fairly and impartially toward the bank and toward the applicant. He is prohibited from deriving any personal gain at the expense of the applicant." *Henkin v. Berea Bank & Trust Co.*, 566 S.W.2d 420 (Ky. Ct. App. 1978).

Here, FKNB stood in a fiduciary relationship to the Sallees and thus owed them a fiduciary duty. First, the relationship between the parties to this case was founded on the trust and confidence the Sallees had in Logsdon,

Cooney, and FKNB. When the Sallees negotiated the laundromat loan, they were not borrowers who approached the Bank for the first time for a loan. Rather, they were already existing customers with whom FKNB and its officers had cultivated a relationship. Significantly, they already had loans with the Bank, which understood their fiscal status. The Bank also arranged for the Sallees to transfer or assign their retirement fund to the Bank, assuring them that their retirement fund would be safe and that an IRA would be established. As the Bankruptcy Court noted, Logsdon and Cooney worked to lull the Sallees into a false sense of security concerning their relationship with FKNB and to induce them to purchase the laundromat. The Sallees were shown confidential Bank documents which purported to show why the laundromat purchase would be a valuable and beneficial undertaking. The Sallees were promised that they could receive another commercial loan if they would purchase the laundromat and the purchase was financed by FKNB. The Bank effectively traded on its preexisting relationship with the Sallees, built up by acts intended to cause the Sallees to place their trust in the Bank, in order to induce them into the laundromat purchase.

Second, this relationship created a duty for the Bank to act for the Sallees' benefit, or at least not to work to their detriment.. While it is true that the Bank was representing the sellers, it also owed the Sallees a duty to act fairly and impartially toward them. Instead, the Bank misled the Sallees for its own benefit, enticing them to enter into an ill-fated and ill-conceived business deal which, even if it failed, would benefit the Bank by effectively transforming FWB's uncollateralized loan into the Sallees' collaterized loan. Furthermore, the Bank not only failed to disclose material facts but affirmatively misled the Sallees by presenting inaccurate, exaggerated appraisals of the laundromat's value, unconnected to any economic reality apart from FWB's massive debts. The Bank, based on these appraisals which they must have known were inaccurate,

seduced the Sallees into a financial transaction involving a purchase price and a loan in excess of the laundromat's value. Finally, the Bank falsely assured the Sallees that their retirement funds would be safe and that the ESOP stock or later proceeds would be placed in an IRA, and instead kept the funds for FKNB's use and benefit at the expense of the Sallees' interest.

The appellants cite *Denison State Bank v. C.C. Maderia,* 640 P.2d 1235 (Kan. 1982), arguing that the case mandates a ruling in its favor. *Denison,* however, is distinguishable from the present case, and the factual dissimilarities and the Kansas court's discussion of bank fiduciary relationships supports the appellees' rather than the appellants' position. The Kansas court noted that fiduciary relationships may be "implied in law due to the factual situation surrounding the involved transactions and the relationship of the parties to each other and the questioned transactions." *Id.* at 1241. The court noted that while the determination of a fiduciary duty is a fact-intensive inquiry, certain broad principles guide the determination of whether the parties are bound In a fiduciary relationship.

First, "a fiduciary relationship imparts a position of peculiar confidence placed by one individual in another." *Id.* The preexisting relationship between FKNB and the Sallees meant that the Sallees placed a certain confidence in the Bank. The Sallees had previous loans with FKNB, which understood and had knowledge of their business and financial needs. The Bank also purported to be managing at least some of the Sallees' retirement fund, creating a position of confidence and trust and assuring them their retirement stock would not be jeopardized. Second, "a fiduciary is a person with a duty to act primarily for the benefit of another." *Id.* While the Bank did have a duty to act for the benefit of FWB, it also had a duty not to entice the Sallees fraudulently into a doomed business transaction and loan. Third, "a fiduciary is in a position to have and exercise, and does have and exercise influence over

another." *Id.* Here, FKNB knew of the Sallees' previous loans and their need for new commercial loans and used that knowledge to the Bank's advantage and the Sallees' disadvantage. Finally, "a fiduciary relationship implies a condition of superiority of one of the parties over the other." *Id.* The Bank knew of the falsity of the appraisal but presented it as factually accurate and used its position of trust to lull the Sallees into a false sense of security, enticing them to purchase the laundromat not only with misinformation but also with false promises of the commercial loan. The Bank then falsely represented that the Sallees' retirement fund stock would be safely keep in an IRA, instead not only not forming an IRA, but transferring the Sallees' interest in the stock to FKNB.

In *Dension,* Maderia, the bank's customer, knew of risks inherent in the business venture. Proof of untrue representations by the bank was minimal at best and the information was equally available to Maderia, a sophisticated business man, represented by counsel. Indeed the court noted, "we are not faced with a situation where a party with superior knowledge used that knowledge to its own benefit to the detriment of the other party who occupied an inferior position without the knowledge, expertise, or ability to ascertain the true facts." *Id.* at 1243. The Sallees, conversely, were not sophisticated business people and were not represented by counsel. The Bank called the Sallees to solicit their business and to arrange the purchase and loan. While they may have been able to discover some of the facts concerning the laundromat had they investigated its earnings, had an independent appraisal done, or retained counsel, the Bank appears to have intentionally engaged in a course of conduct meant to dissuade the Sallees from doing so. While it might have been wiser for the Sallees to have conducted their own investigation, the court cannot conclude that they tailed to exercise ordinary care, in light of their relationship with the Bank and the Bank's deliberate — and effective — misrepresentations.

The Release

The appellant argues that the Bankruptcy Court erred in holding that a release agreement does not bar the Sallees' fraud and breach of fiduciary duty claims. The Sallees counter that the release was obtained by contemporaneous deceit and does not bar those claims.

At the end of 1989, the Bank granted the Sallees a ninety-day extension on payments on the laundromat loan. The Extension/Waiver Agreement included a release, signed by the Sallees, stating,

> For the sole consideration of the extension of this debt as set forth in this agreement, the sufficiency of which is hereby acknowledged, the Borrowers hereby waive, release, and forever discharge the Bank from and against any and all rights, claims, or causes of action with respect to the Loan Documents and Collateral which occurred before the date of this agreement.

The Bank argues that this release precludes the plaintiff's claims for breach of fiduciary duty and fraud. The Sallees counter that the Release was procured by contemporaneous fraud, namely that Logsdon orally promised that when he was made president he would be able to make the Package Loan they requested. On December 18, 1989, however, Dickinson and the FKNB board had terminated all commercial lending made without DFC approval, including renewals or extensions of existing loans, ending any chance Logsdon had to make good on his and FKNB's promise of a package loan. Logsdon did not inform the Sallees of this new policy when he promised the Sallees they would receive a Package Loan.

The terms of an unambiguous contract cannot be varied by extrinsic evidence. *O.P. Link Handle Co. v. Wright,* 429 S.W. 2d. 842 (Ky. 1968). Thus, a court may not consider parol evidence when interpreting a contract unless the contract is ambiguous. *Schachner v. Blue Cross and Blue Shield of Ohio,* 77 F.3d 889, 893 (6th Cir. 1996). Contract language is not ambiguous unless it is subject to two reasonable interpretations. *Id* at 893. The ambiguity

must be patent and apparent on the face of the contract. *Id.* Whether the language of a contract is ambiguous is a question of law for the court. *Overberg v. Lusby,* 727 F. Supp. 1091 (E.D. Ky. 1990)

The determination that a contract suffers from ambiguity must be based upon the common, plain meaning of the language of the contract. *Kentucky-West Virginia Gas Co. v. Browning* 521 S.W.2d 516 (Ky. 1975). A court, however, is not required to read a contract in a vacuum: "A contract is to be construed as a whole so as to ascertain and give effect to the true intent of the parties, and the circumstances under which the Contract was executed and the conduct of the parties thereafter can be considered by the Court in determining what their intention was, without it becoming a violation of the parol evidence rule." *Rudd-Melikian, Inc. v. Merritt,* 282 F.2d 924, 928 (6th Cir. 1960). Nevertheless, before a court may consider extrinsic evidence of the parties' intent, "it must find an ambiguity on the face of the contract." *Schachner,* 77 F.3d at 893. Indeed, "a contract is not rendered ambiguous simply because the parties do not agree on its proper construction or their intent upon executing the contract." *Overberg,* 727 F.Supp. at 1093.

Parol evidence consists of evidence of agreements between, or the behavior of, the parties prior to or contemporaneous with the contract, This includes "evidence of a contemporaneous oral agreement on the same subject matter, verifying, modifying, contradicting or enlarging" a contract. *M.R. Kopmeyer Co. v. Barnes,* 276 S.W.2d 21, 23-24 (Ky. 1955). Barring an ambiguity, such evidence cannot be admitted. "If the language is unambiguous, the meaning of the language is a question of law, and the intent of the parties must be discerned from the words used in the instrument." *Taggart v. U.S.* 880 F.2d 867, 870 (6th Cir. 1989). In this case, the language of the release is not ambiguous. The court will not create an ambiguity where none *exists. See Friction Materials Co., Inc. v. Stinson,* 833 SW.2d 388 (Ky. Ct. App. 1992). Thus, parol evidence is not admissible to vary the terms of the release.

Parol evidence is admissible, however, to establish fraud or mistake in the inducement to enter a contract. *In* re *Cannonsburg Environmental Associates,* 72 F.3d 1260 (6th Cir. 1996). If "the injured party is fraudulently induced to enter into the contract in the first instance . . . parol evidence is appropriately admitted not to vary the terms to the written agreement but to vitiate the agreement based on the fraudulent inducement." *Ferguson v. Cussins,* 713 S.W.2d 5, 6 (Ky.Ct.App. 1986), *citing Bryant v. Troutman.* 287 S.W.2d 918 (Ky. 1956). If the injured party "was induced to enter into the contract in reliance upon the false representations, he may . . . sue for damages suffered on account of the fraud or deceit." *Bryant,* 287 S.W.2d 920.

Here, this Court finds that as the release was procured through fraudulent misrepresentation, it is unenforceable. *Overberg v. Lusby,* 727 F. Supp. 1091 (E.D. Ky. 1990). While the Bankruptcy Court did hold that "FKNB did not defraud the Sallees concerning the promises of future financing as the evidence does not clearly demonstrate that at the time Cooney and Logsdon made their promises of future financing, they were unwilling or absolutely unable to make the promised loans,"[6] the court also found that Worth Sallee signed the release because Logsdon represented to him that he would receive a Package Loan. At the time Logsdon made that representation he knew that such a loan would be impossible due to the restructuring

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[6] On the issue of fraud the court does not discredit the Bankruptcy Court's factual findings or credibility determination. The Bankruptcy Court's determination that Cooney and Logsdon did not defraud the Sallees through their promises of future financing, however, is determinative of a separate legal issue, whether the failure to provide the Package Loan was itself fraudulent, not the issue here, whether the promise of the Package Loan was a misrepresentation made in order to fraudulently induce the Sallees to sign the release. Because the Bankruptcy Court's analysis of the release differed from this court's, the Bankruptcy Judge did not reach the instant issue.

at FKNB. Under Kentucky law, fraud is "(1) a material misrepresentation; (2) which is false; (3) which was known to be false; (4) made with the inducement to be acted upon; (5) which is acted upon in reliance thereon; and (6) causes injury." *Moore, Owen, Thomas & Co. v. Coffey,* 922 F.2d 1439, 1444 (6th Cir. 1993); *In Re Cannonsburg Environmental Assoc., Ltd.,* 72 F.3d 1260 (6th Cir. 1996). Logsdon's assurances concerning the Package Loan were material misrepresentations, false and known to be false, and made with the intention that the Sallees sign the release, thereby waiving their right to suit. In short, they were fraudulent.

Furthermore, a release between two parties in a fiduciary relationship must be evaluated "as one obtained by a fiduciary from a beneficiary." *Street v. J.C. Bradford & Co.,* 886 F.2d 1472, 1481 (6th Cir. 1990) (applying federal common law). Such a relationship requires the fiduciary to disclose material facts, which Logsdon clearly failed to do when he falsely stated that the Sallees could still receive a Package Loan. The Restatement of Contracts 2d § 173 explains that abuse of a fiduciary relationship makes a contract voidable:

> If a fiduciary makes a contract with his beneficiary relating to matters within the scope of the fiduciary relation, the contract is voidable by the beneficiary, unless:
>
> (a) it is on fair terms, and
>
> (b) all parties beneficially interested manifest assent with full understanding of the legal rights and of the relevant facts that the fiduciary knows or should know.

Id. Here, the Sallees did not have all the relevant facts that they should have known. Indeed, because of Logsdon's misrepresentations the Sallees had a false understanding of the circumstances under which they were signing the release.

Damages

Actual Damages

FKNB argues that the Bankruptcy Court erred in calculating the Sallees' actual damages by incorrectly applying the benefit-of-the-bargain damage formula. Specifically, the Bank explains that in determining the actual damages that the Sallees incurred as a result of FKNB's fraud and breach of fiduciary duty relating to the purchase of the laundromat, the measure of damages should have been $421,000.00, the difference between the value of the laundromat as represented, $726,000.00, and its actual value at the time of the misrepresentation, $305,000.00. Instead, the Bankruptcy Court determined the damages based upon the difference between the value of the laundromat as represented and the price at which the laundromat was sold at a United States Marshal's sale, four years after the loan was made, resulting In a damages award of $549,999.00. The Sallees counter that the Bankruptcy Court should have used the $750,000.00 appraisal rather than the $726,000.00 appraisal and thus any error was in the Bank's favor. Additionally, they suggest that the price at the Marshal's sale was a better measure of the true value of the laundromat. The Bankruptcy Court based its damages calculation on the sale price because it reasoned that the price "better represent[ed] the damages suffered by the Sallees and the bankruptcy estate, given the fact that the sale price forms the basis of [the Bank's] deficiency claim against the Sallees and the bankruptcy estate [and the Bank did not reduce] the claim against the estate to reflect the actual value of the liquidated collateral."

Under Kentucky law an individual damaged by a fraudulent representation may collect the "benefit of the bargain," that is, what the property would have been worth had it been as represented. *Dempsey v. Marshall*, 344 S.W.2d 606, 607 (Ky. Ct. App. 1961). "In such cases, the measure is generally held to be the difference between the actual and represented value of the business or property."

Id. In other words,

> [t]he measure of damages for fraud is, as a general rule, the actual pecuniary loss sustained. Thus, as a general rule, one injured by the commission of fraud is entitled to recover such damages in a tort action as will compensate him for the loss or injury actually sustained and place him in the same position as he would have occupied had he not been defrauded.

Sanford Construction Co. v. S&H Contractors, Inc., 443 S.W.2d 227 *(Ky.* Ct. App. 1969). Here, had the Bank not defrauded the Sallees by misrepresenting the value of the laundromat, they would have purchased the property for its fair market value, at the time of the purchase appraised at $305,000.00, rather than $726,000.00. The benefit of their bargain would have been $421,000.00. The Bankruptcy Court's award of $549,999.00 was clearly erroneous as it not only gave the Sallees the benefit of their bargain but also compensated them for economic changes affecting the value of the laundromat, independent of the fraud. Thus the court will reduce the actual damages award by $128,999.00 to $421,000.00.

Value of Loss of Worth of Retirement Plan

The Bankruptcy Court held that had FKNB not induced the Sallees to purchase the laundromat, the Sallees would not have touched their Lowe's ESOP stock, but would have left it in a self-directed IRA to grow. Furthermore, the Court explained, FKNB misrepresented to the Sallees the nature and existence of the IRA when convincing the Sallees to sell the stock and explaining the ramifications of such a sale. Had the funds been left in an IRA, the stock's value at the time of trial would have been $1,170,000.00.

The Bank argues that the Bankruptcy Court erred in awarding the Sallees damages for the lost worth of their retirement plan based upon the 1999 market value of the 5,999 shares of stock because the Sallees had previously authorized the sale of the stock in 1990 and agreed to use the proceeds to pay other debts. The Bank further asserts that FKNB was legally precluded from creating an IRA

with the Sallees' Lowe's stock because it had been pledged or assigned to Hardin County and was not eligible to be placed in an IRA. Additionally, FKNB could not have rolled over the amount from Worth's account into an IRA.

The Sallees counter that the purpose of compensatory damages is to restore the injured party to the same position he would have been in had the wrongdoing not occurred. They argue that had the fraud not occurred, their stock would not have been used as collateral; they had not intended to use the stock as collateral and had been assured by Logsdon and FKNB that an IRA had been set up and that the stock could be rolled over into an IRA that would be replenished after the Package Loan was approved. Furthermore, they explain that Sallee did not intend to place the stock with Hardin County as collateral and it had not been successfully pledged or assigned to that bank.

The court agrees with the Bankruptcy Court's analysis. Had FKNB not defrauded the Sallees, they would not have lost the value of their stock. First, taking a broad view of the case, had the Sallees not been duped into the laundromat purchase and accompanying loan, the stock may never have been disbursed or used as collateral to begin with or been burdened with IRA ineligibility. Second, Logsdon and FKNB misrepresented to the Sallees what was happening and would happen to their stock. The Bank stated that a nonexistent IRA had been created and that it could be replenished after the stock sale through the Package Loan, clearly a misrepresentation. The Agreement entered into on May 31, 1989 appears only to transfer an IRA or certificate of deposit to the Bank for the duration of the loan rather than transferring the interest in the stock to the Bank in any way. While replenishment of the IRA account may not have been possible under ERISA and IRS regulations, the Sallees agreed to the transactions affecting their stock only after FKNB assured them this was possible, that the Bank would not touch their retirement money, and that it would be safe. Third, the Sallees' "assignment" of the stock to Hardin County does not appear

to have been an effective assignment that would have affected their stock's IRA-eligibility. In reviewing the assignment form, the Bankruptcy Court concluded that when Sallee signed the document the security section was blank and any assignment would not have resulted in an automatic assignment. The faulty and uncompleted assignment renders FKNB's argument regarding the tax implications of an assignment under 26 U.S.C. 72(p)(1) a red herring.

As the Sallees' stock would not have been pledged as collateral, disbursed, or otherwise rendered IRA-ineligible absent the Bank's misconduct, an award of the lost value of retirement plan stock is appropriate compensatory damages.

Punitive Damages

The Bankruptcy Court awarded the Sallees $1,200,000.25 in punitive damages, or 75% of the awarded compensatory damages of $1,710,000.00. DFC does not argue that the amount violates federal due process or is otherwise excessive. Rather, it explains that as DFC intervened in FKNB's commercial lending practices and has sold the Bank, the award is improper because it will not serve the deterrent goal intended by punitive damages by punishing the wrongdoer in this case. In support of its argument, DFC cites *Stewart v. Southeastern Group, Inc.*, 1999 WL 1078201 (Ky. Ct. App. 1999), in which the Kentucky Court of Appeals held that punitive damages were not recoverable against the estate of a deceased tort-feasor because the estate "had no connection with or responsibility for his wrongful act." *Id.* This case is easily distinguished, however, as DFC is connected to and responsible for the wrongdoing perpetrated by FKNB.

FKNB was controlled by DFC during the course of its relationship with the Sallees. DFC clearly did not adequately supervise or constrain FKNB's lending practices, and when problems were discovered, DFC warned Logsdon and other Bank employees before loan portfolios were reviewed. Thus, DFC's own negligence and failure to act was at least in part directly responsible for the Sallees' inju-

ries. DFC did nothing in this case to remedy FKNB's wrongdoing by, for example, restructuring or forgiving the Sallees' loans. This corporate complicity in FKNB's wrongdoing merits the imputation of punitive damages to DFC. *See generally Jannotta v. Subway Sandwich Shops, Inc.,* 125 F.3d 505 (7th Cir. 1997). Second, DFC is responsible for FKNB's wrongdoing as the Bank's holding company. When it sold FKNB's assets, DFC assumed direct responsibility for the Bank's actions after it agreed to indemnify the new owners for the costs of the bad loans and the ensuing litigation. Finally, the punitive damage award will serve to deter other banks, both those still owned by DFC and independent banks, from similar conduct, furthering the purpose of an award of punitive damages.

The court sees nothing unreasonable in awarding punitive damages based on a percentage of compensatory damages. The punitive damages awarded were 75% of the compensatory damages and in light of the adjustment of the compensatory damages, this court remands this case to the Bankruptcy Court for a recalculation of the punitive damages. Accordingly,

IT IS ORDERED that the motion is GRANTED in part and is DENIED in part. This the 21st day of March, 2000.

/s/ Jennifer B. Coffman
Jennifer B. Coffman, Judge
United States District Court
Western District of Kentucky

Entered: March 22, 2000

APPENDIX D

UNITED STATES BANKRUPTCY COURT

WESTERN DISTRICT OF KENTUCKY

Case No. 92-30062(1)7
A.P. No. 92-3035

FORT KNOX NATIONAL BANK,

Plaintiff,

versus

WORTH A. SALLEE, Et Al,

Defendants and Counter-Plaintiffs,

versus

DICKINSON FINANCIAL CORPORATION,

Third-Party Defendant.

ORDER AND JUDGMENT—Entered September 15, 1998

This matter coming before the Court on the trial of the above adversary proceeding and this Court having conducted a 38 day trial, made extensive findings of fact and conclusions of law which are set forth in a 71 page memorandum opinion ("Opinion") entered with this judgment and being otherwise sufficiently advised;

IT IS THEREFORE ORDERED that, for the reasons set forth in the opinion, the above bankruptcy estate be and hereby is GRANTED a judgment against Fort Knox National Bank on the estate's counterclaim in the amount of $3,009,998.25, said amount bearing interest at the current federal judgment rate of interest.

THIS IS A FINAL AND APPEALABLE ORDER.

/s/ Henry H. Dickinson
Henry H. Dickinson
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT

WESTERN DISTRICT OF KENTUCKY

Case No. 92-30062(1)7
A.P. No. 92-3035

FORT KNOX NATIONAL BANK,

Plaintiff,

versus

WORTH A. SALLEE, Et Al,

Defendants and Counter-Plaintiffs,

versus

DICKINSON FINANCIAL CORPORATION,

Third-Party Defendant.

MEMORANDUM OPINION

—Entered September 15, 1998

In numerous judicial decisions written throughout the years, Courts have lamented the fact that parties do not present enough evidence concerning their claims or defenses to permit an informed decision. That problem is clearly not present in the above action between Fort Knox National Bank ("FKNB") and Dickinson Financial Corporation ("DFC") , on the one hand (collectively "Defendants") and the debtors, Worth and Sandra Sallee (collectively "Sallees") This case, involving a commercial loan gone bad, has been as exhaustively investigated and viciously litigated as any action in the entire Western District of Kentucky during the past decade. The facts are complex and will be set forth in extensive detail below.

Factual Findings

Before discussing the transactions between the Sallees and FKNB and DFC it is necessary to set forth the background facts which led to the loan transaction at the crux of this lawsuit.

FKNB was, prior to its acquisition by DFC, a small banking institution located on the military post of Fort Knox, Kentucky. Its primary business was to provide a wider range of consumer banking services to Fort Knox military personnel and the citizens of the surrounding communities of Radcliff, Kentucky. In January of 1985, Gary Dickinson[1] ("Dickinson") and several other investors acquired the stock of Investor Services, Inc., the holding company of FKNB. Dickinson acquired the majority of the stock in FKNB holding company and also was the majority owner of DFC.

DFC is basically a holding company for a number of banks. DFC banks primarily fall into two categories, banks at U.S. Military Posts ("Military Banks") and community banks located in rural Missouri ("Rural Banks"). Both FKNB and DFC's banks primary focus was consumer banking services, with only a modest amount of commercial lending. There is also some significant agricultural lending at the Rural Banks. However in mid to late 1980's, like a large number of other lending institutions, FKNB decided to increase its commercial lending, which ultimately grew to approximately 40% of FKNB total loan portfolio.

Unfortunately for FKNB, at approximately the same time they decided to increase their commercial lending, Fred W. Bramblett ("FWB") decided to become a real estate developer. As an aside, FWB was not very successful in this occupation, and now works as a part time mechanic/crewman for a professional motorcycle racing team. Further, this Court finds much of FWB's testimony to be less than credible and he admitted under oath, that he gave false testimony to the Kentucky Real Estate Commission, in connection with an investigation of certain real estate escrow accounts which he once controlled (more on this

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[1] Dickinson to the best of the Court's knowledge, is not in any way related to the Honorable Henry H. Dickinson, the presiding Judge in this case.

later). However, in a few cases, this Court found FWB's testimony to he somewhat believable.

In 1983, FWB formed F.W. Bramblett Builders, Inc. ("BB Inc.") for the purpose of building and selling single family houses and duplexes. BB Inc. initially obtained financing for certain specific construction projects. However, its development activities rapidly increased, as did its line of credit throughout 1983-1984. By early 1985, FKNB had extended to BB Inc. a $250,000.00 line of credit. The amount of this line of credit was increased to $425,000.00 in October of 1985. The loan proposal approved by FKNB at that time shows that FWB and BB Inc. claimed to have a combined net worth of approximately $370,000.00. BB Inc. also obtained additional loans from FKNB during this time including a $43,875.00 loan in July of 1986 and a $40,000.00 loan to acquire Rose Realty.

In late August of 1986, FWB formed Vertex Construction ("Vertex") which, although the evidence is not clear, apparently took over at least some of the assets, and business of BB Inc. This change is somewhat strange in that the net worth of BB Inc. went from a stated $71,496.13 in July of 1986 to a negative $48,795.00 on August 31, 1986. This negative net worth is actually understated by approximately $120,000.00 since by September of 1986, BB Inc. owed FKNB over $354,000.00, not the approximate $235,000.00, set forth in BB Inc.'s financial statement. Nevertheless, on September 25, 1986 FKNB renewed BB Inc.'s, now Vertex's, line of credit on the apparent "strength" of Vertex and FWB assets.

As noted above in 1986, FWB expanded his real estate development business by acquiring Rose Realty, which both sold real estate and managed property through its Better Homes and Garden's Property Management Division. As part of its property management operations, Rose Realty maintained accounts not only for its own operations, but also accounts which contained rental payments owed to the owners of the property it managed and security deposits paid by tenants in the properties operated by Rose Re-

alty. Although it is unclear from the Bank's records and the lengthy, confusing and contradicting testimony presented at trial, whether the rental and security deposit accounts were actual escrow accounts, it is clear that these accounts solely contained funds that were the property of other persons and entities.

During the Spring of 1987, FWB continued to expand his construction business with the enthusiastic assistance of FKNB. On at least two occasion the bank through its then Senior Vice President, Kenny Logsdon, wrote glowing, general letters of recommendation for FWB. In April of 1987 FKNB loaned $35,000.00 to FWB as operating capital for FWB's real estate and construction business. According to the bank documents at the time of this loan FWB's various enterprises had paid down their debt to FKNB to approximately $250,000.00. By May of 1987, FKNB started making individual construction loans to Vertex and Webco for building houses in the Meadowlake Subdivision. The initial three totaled approximately $139,000.00. They were apparently never cross collateralized.

In May of 1987, Vertex entered into a commercial construction contract for the building of a "Super 8 Motel" for Peter Schwan and James Aldridge. The amount of the contract was Vertex's cost plus between $50,000.00 and $70,000.00 depending on the motel's size. This contract was partially financed by a series of short term notes including:

Date	Amount
July 8, 1987	$15,000.00
August 27, 1987	5,000.00
September 18, 1987	5,000.00
October 23, 1987	10,000.00
October 26, 1987	10,000.00
March 7, 1988 (2 notes)	21,000.00 (total)

The Court finds that FWB also used funds from loans on other projects to pay for the Super 8 construction project. FKNB had some knowledge of the diversion of these funds

to the Super 8 project. Inexplicitly, FKNB never took an assignment of the entire Super 8 contract as collateral of its loans, but merely obtained piecemeal assignments of small bits of its contract to secure its individual loans. Further, these assignments seem to be ineffective as they are not signed by Schwan and Aldridge.

By the early Fall of 1987 FWB began to experience significant financial difficulties. On October 22, 1987 FWB obtained a refinancing of $48,000.00 of debts, secured by the inventory, equipment and receivables. This loan was approved in spite of the creative financial information provided by FWB to FKNB which apparently FKNB neither verified or ever seriously reviewed. FKNB also increased FWB's line of credit to $250,000.00 and made an additional $4,400.00 loan to Vertex on October 30, 1987 taking as collateral "the right to receive money" under a previous loan made by FKNB to Vertex.[2]

In the Winter of 1987 FWB's construction/real estate empire began to crumble. Schwan and Aldridge became dissatisfied with FWB's work and refused to pay him under the Super 8 contract. For whatever reason FKNB apparently never pursued its security interest in the Super 8 contract. Further during this period Logsdon admitted that FKNB was aware of FWB's financial problems. Unfortunately for all concerned FKNB did not pull the plug on FWB's failing business.

In January of 1988, FWB began construction of various houses in the Academy Heights Subdivision. Once again FKNB financed Webco in this endeavor, by making individual loans on individual building lots. This time the promissory notes did disclose the possibility of cross collateralization. The total amount of the initial loans was approximately $134,000.00. These projects were insufficient to stop FWB's financial collapse.

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[2] No this is not a mistake, FKNB took a security interest in the "disbursements" available under an earlier FKNB loan.

Sometime in late January of 1988, FWB went to see Logsdon and informed him that he was broke and was planning to file bankruptcy. The two participants in this meeting tell widely different versions of their conversations. FWB states that Logsdon actively sought his promise not to file bankruptcy and set forth an elaborate scheme by which FWB would begin acquiring property on which FKNB would lend 100% to value (or more) and would use the proceeds of these 100% loans to allow FWB and his businesses to remain current on his debt to FKNB. The apparent end result of this "plan" was to have either FWB's business turnaround or the properties sold to other entities for sufficient funds to pay FWB's loans. FWB testified that Logsdon went into great detail about how this "workout" of his loans was to proceed.

Logsdon, by contrast, only vaguely remembers this conversation. He does not recall any of the details of the conversation and was unable to confirm or deny whether: 1) FWB told him that he (FWB) was broke and planning to file bankruptcy; 2) he told FWB that FKNB would agree to work with FWB; and/or 3) he told FWB that FKNB would make 100% loans to FWB. Indeed the only clear memory which Logsdon had of the meeting was that he did not instruct FWB on how to conduct his future business.

In this case, this Court finds that neither version of the meeting testified to by the participants is entirely accurate. FWB's version of events, portraying him as a helpless pawn of a banker who thought up a highly risky, complex and detailed workout plan during the course of a single business meeting, strikes this Court to be primarily a highly embellished fantasy. Many of the details recounted by FWB and his characterization of his role simply are not truthful. However, in light of the events which followed, Logsdon's version of a short meeting as one where FWB merely dropped by to say he was having some vague financial troubles is also inaccurate. This Court finds that, whatever the details, FWB and Logsdon agreed to a generalized workout strategy which would entail FWB, his businesses,

various Bramblett family members and other Bramblett associates obtaining more loans from FKNB to be used in part to keep FWB's various loans from going bad until either FWB could pay his obligation or sell his projects to satisfy his debt to FKNB. This Court agrees with the bankruptcy estate's expert that this otherwise inexplicable series of loans, made by FKNB to FWB and other related parties, were part of a plan (admittedly a bad one) to "workout" FWB's bad loans. We respectfully reject the testimony of FKNB's expert that there was no workout plan.

The first steps of this plan involved using Academy Height loan proceeds to pay some of Bramblett's interest charges at FKNB and loaning Webco over $12,000.00 to refinance a 4 year old Jeep Wagoner which was worth between $7,000.00 and $8,000.00. The proceeds of this loan were used to keep FWB current on his FKNB loans. Logsdon and FKNB further helped FWB by writing additional general letters of financial recommendation (see attached exhibit A). With Logsdon's clear knowledge of Bramblett's financial problems, the February 11, 1988 letter establishes that Logsdon and FKNB clearly intended FWB to enter into new deals to continue the flow of cash to service his debt.

In April of 1988, FKNB loaned FWB the sum of $307,500.00 for the construction of a strip mall in Elizabethtown, Kentucky. This loan brought FWB's debt at FKNB over its internal lending limits by at least $7,500.00. This loan was supported by an "appraisal" by one David Banet ("Banet") which estimated the value of the completed center at $410,000.00. After reviewing the appraisal, this Court notes that, except for other similar appraisals made by Banet for FKNB, it is the worst prepared appraisal it has had the opportunity to review in its past ten years on the bench.

FWB, showing his typical brilliance, believed he could build this shopping center for between $220,000.00 and $250,000.00 and that a large percentage of the loan proceeds could be used to service his other debts. In fact, as

noted by plaintiff's exhibit 71 (attached hereto as exhibit B) a significant amount of the proceeds of this loan were used to pay debt service on FWB's various debts with FKNB and to keep Vertex's checks from bouncing. Unfortunately, FWB was again wrong in his estimate of the building costs and the shopping center's construction lagged.

In September of 1988, Gary Smith, President of Pioneer Capital Mortgage Co., a subsidiary of FKNB contracted with FWB to purchase the shopping center. The purchase contract was made through FWB's Rose Realty. Among the conditions to this contract were the requirements that the shopping center be completed, according to its plans by the closing date and that FWB had to deliver the property to Smith in a "completed, ready to occupy state." The contract was entered into on September 2, 1988, when the property was only approximately 35%-45% complete, and expired by its terms on October 30, 1988.

On November 17, 1988, almost 3 weeks after the Smith contract had expired, FKNB loaned FWB an additional $102,500 on the shopping center protect (bringing the total amount of debt on the property to $410,000.00 the sale price and appraised value of this contract). This loan was secured by an assignment of the expired Smith contract. While FKNB argues Smith's agreement to the assignment of the contract demonstrates his willingness to proceed with the purchase, this Court has been unable to find any law or facts which demonstrate this contract was in any way extended. FKNB retained the initial $19,040.87 of the loan and the remainder of the loan was apparently used to finish the shopping center. This activity was for naught however and Smith ultimately decided not to purchase the shopping center due to among other things, the poor quality of the workmanship in the building of the center and the amount of debt on the center. However, as we shall see later FWB found a buyer for the shopping center.

During the shopping center debacle, the debtors', Worth and Sandra Sallee, began their lending relationship with FKNB in August of 1988. At the time of their initial bor-

rowing, Worth Sallee was a manager at Lowes in Clarksville, Indiana. He had been transferred there from his position as the Lowes manager in Elizabethtown, Kentucky. Worth was unhappy with this transfer and he and his wife were exploring the possibility of purchasing a business in Elizabethtown, Kentucky. The business they choose was a convenience food store owned by FWB's brother, James "Jimmy" Bramblett ("Jimmy"). Jimmy suggested that they obtain financing from FKNB.

After the Sallees discussed this matter with Logsdon, Jimmy sold them the convenience store, which was apparently owned by an entity known as Bramblett Properties, Inc. for $100,500.00. Jimmy however did not sell the Sallees the real estate and building which comprised the convenience store, but instead leased the real property to the Sallees for 5 years at $5,000.00 per month and granted the Sallees an option to purchase the real estate for $550,000.00. Worth Sallee met with Logsdon who thought Sallees' purchase was a good idea. Logsdon obtained approval of the $100,000.00 loan based upon the Sallees' net worth l $211,870.00 as of June 5, 1988 (see attached exhibit C and secured the loan with a mortgage on the Sallees' house, Worth Sallees' profit sharing plan and the store inventory and equipment.

According to Worth Sallee, Logsdon also wanted to have Sallee's ESOP stock plan placed in FKNB. This Court believes Mr. Sallee's testimony that Logsdon never discussed taking a security interest in his ESOP assets although it is clear from the testimony of Logsdon and the documentation placed before the Court that Logsdon fully intended to obtain Sallee's ESOP stock as collateral for FKNB's loan to the Sallees. This intent was not realized by Logsdon at this time. The Court also notes the extreme interest Logsdon had in securing the Sallee notes as opposed to his and his subordinates incredibly lax attitude about collateral concerning FWB's loans.

On August 1, 1988 Worth Sallee executed a letter to Lowes directing that all of his stock in his ESOP account

be sent to FKNB when Sallee retired and the stock was distributed to him by the ESOP plan. The $100,000.00 loan was ultimately made in two parts, an $80,000.00 note on August 3, 1988 and a $20,000.00 loan on August 10, 1988. Regretfully for the Sallees, the food store was not extremely profitable. In October of 1988, the Sallees' obtained a new loan from the Hardin County Bank & Trust Co. in the amount of $125,576.00. The proceeds of the loan were used to payoff the Sallees' FKNB loans. The Sallees believed that the Hardin County loan would be secured with a security interest in the food store assets and a second mortgage on the Sallees' home. The Sallees also said they consented to have Worth's ESOP and Profit Sharing plan stock "assigned" to Hardin County. While this Court believes Worth Sallee's testimony that he did not intend to pledge his Lowes stock to Hardin County[3], he did consent to an assignment of the stock to Hardin County, which he naively believed would be placed in an IRA account, without Hardin County taking a security interest in this stock. This belief is indicative of Worth Sallee's total lack of any understanding of business or financial matters and his almost childlike trust in banks. Despite Sallee's belief, based upon his consent to an "assignment" of the ESOP and Profit Sharing Stock, Hardin County attempted to take a security interest in Worth Sallee's stock. This attempt failed because, as we will see later Hardin County never obtained possession of the ESOP or profit Sharing Stock and was prevented by the provisions of ERISA from taking a security interest in the accounts.

Meanwhile, FWE was still fighting to survive. In September of 1988 he proposed swapping his real estate in Academy Heights to Dick Booher and Pat Roush ("Roush") for a convenience store known as P&J Food Store. Although

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[3] This testimony is supported by the fact that the collateral portion of the Hardin County note was left blank, with the permission of the Sallees at the time the note was signed.

there is conflicting testimony as to whether Logsdon actually suggested this transaction, it is apparent the concept of FWB selling the Academy Heights property was appealing to Logsdon and FKNB. In late September, Roush with the financing by FKNB, purchased FWB's Academy Heights real estate. Although the Roush Academy Heights loan file has been lost by the bank the Academy Heights transaction occurred as set forth in a March 9, 1995 letter from DFC's counsel to the Sallees' counsel:

> 1. The Payoff on the Academy Heights properties was as follows:
>
> | | | | | | | |
> |---|---|---|---|---|---|---|
> | 00938009-89 | | $ 25,381.79 | Lot | 22 | Academy | Heights |
> | " | -85 | 32,160.21 | Lot | 3 | " | " |
> | " | -87 | 35,674.36 | Lot | 5 | " | " |
> | " | -84 | 23,077.69 | Lot | 21 | " | " |
> | " | -81 | 28,825.00 | Lot | 20 | " | " |
> | " | -86 | 33.989.53 | lot | 7 | " | " |
> | | | $179,108.58 | | | | |
>
> 2. Pat Roush signed a note for $206,525.00. Of that note he received an officer's check in the amount of $4,972.50, the proceeds of which he deposited into his checking account with FKNB. The balance remaining of $201,552.50 was applied in combination with F.W. Bramblett final draw on the original strip center loan, in the amount of $18,290.34, and F.W. Bramblett draw on $102,500.00 loan secured by Smith contract, In the amount of $12,040.97, totaling $231,883.81. Of this amount; $43,775.23 was devoted to the payment of outstanding bills and accounts due Burnett's Electric, Knotts Supply, National Building Systems, and Lowes of Indiana. $9,000.00 was deposited into a Pat Rousch escrow account, and $179,108.58 paid off the 6 notes due FKNB. I have attached the pertinent checks numbered FK006148, FK006155, FK006156, FK006149, FK006150, FK006151, and FK006152. Credit memos consisting of:

Date	Name	Amount
11-21-88	Webco Homes, Inc.	$25,381.79
11-21-88	Webco Homes, Inc.	32,160.21
11-21-88	Webco Homes, Inc.	35,674.36
11-21-88	Webco Homes, Inc.	23,077.69
11-21-88	Webco Homes, Inc.	28,825.08
11-21-88	Webco Homes, Inc.	33,989.53

And one deposit slip for $9,000.00 to the Pat Rousch escrow account, dated 11-22-88.

In other words, to payoff Webco's Academy Heights loan from FKNB and the mechanics liens against the property, FWB diverted, with the knowledge and agreement of FKNB, $18,290.30 from the proceeds of the first shopping center loan and $12,040.97 from the second shopping center loan to combine with the Rousch loan proceeds to pay off the mechanics liens and Academy Heights mortgage. Given FWB's track record, paying over $30,000.00 to sell real estate is a "good" deal.

Throughout the late Fall of 1988, the Sallees continued to have cash flow problems with the convenience store. In December the Sallees obtained an additional working capital loan of $30,300.00 from Hardin County. As collateral for the loan the Sallees' attempted to grant a security interest in Worth's Profit Sharing Stock account to Hardin County Bank. Once again the documentation is curious, in that while the demand note purports to grant a security interest in the Profit Sharing account stock, the assignment executed by Sallee purports to grant a security interest in both the ESOP and Profit Sharing account stock. Further as a matter of law the assignment is ineffective as Federal ERISA provisions prohibit the granting of even a voluntary security interest in stock held in pension plans such as this one. Hardin County also suggested that due to the Sallees' inability to generate any financial data for their business, that the Sallees' gasoline financing be taken elsewhere. In January of 1989, this led to the Sallees returning to FKNB for additional loans.

In their December 29, 1988 meeting, FKNB's Loan and Discount Committee reviewed a number of loans, including at least one FWB loan. Next to the discussion of the FWB loan is the notation "loans sold". According to the testimony of the late Clarence Pratt, formerly a Colonel in the U.S. Army, ("Col. Pratt") stationed at Fort Knox, this notation referred to the infrequent circumstance when a new borrower would take over payments on a loan. Although Col. Pratt passed away prior to the trial of this matter, both parties to this litigation agreed that Col. Pratt was an honest and honorable individual. Unfortunately, Col. Pratt was, in this case, mistaken about both the frequency and innocence of this type of transaction.

In late January of 1989, the Sallees resumed their borrowing relationship with FKNB. Their business was solicited by Victoria Cooney ("Cooney") the banks second most senior lending officer who directly reported to Logsdon. The Sallees' obtained a $50,000.00 loan for the purchase of gasoline inventory on or about January 24, 1989. This loan was secured by a purported security interest in Worth Sallee's ESOP and Profit Sharing Plan Stock. A significant amount of testimony was developed as to whether Worth Sallee actually signed a letter to Lowes ESOP plan administrator to send his ESOP stock to FKNB or whether his signature was forged. Although the evidence on this matter was inconclusive, it is clear that Sallee did sign the loan agreement and agreed to assign his ESOP plan stock to FKNB. Although the granting of a security interest in such stock is invalid under ERISA, it is clear that an attempt to assign or pledge such assets has adverse tax consequences as discussed below. The Court further believes Worth Sallee's testimony that he did not believe he was granting FKNB a security interest in his ESOP or Profit Sharing Plan.

Further, in early 1989 Cooney purchased a house from FWB. Although the plaintiff makes much of this transaction this Court, after reviewing the mountain of evidence presented on this matter, finds that nothing sinister hap-

pened in connection with this loan other than Cooney may have had bad judgment concerning her choice of home builders and that there were irregularities in her closing statements.

Beginning November 1988, the Office of the Controller of the Currency ("OCC") performed a safety and soundness examination of FKNB. In February of 1989 they had an exit interview with the FKNB Board of Directors and were critical of FKNB's loan practices. Based upon this examination, DFC initiated its own loan review in April of 1989. Significantly Logsdon had advance knowledge when DFC loan review was to make its inspection of DFC loan portfolio.

In March of 1989, FWB was able to sell his shopping center to Dick Booher ("Booher"). As a result of this sale, FWB was able to pay off the initial shopping center loan and obtain a note from Booher for $100,000.00 which was immediately pledged to FKNB as additional collateral. A separate suit by Booher against FKNB is currently pending in the Kentucky State Court.

With the sale of the shopping center to Booher complete, and some of FWB's loans paid off, FKNB and FWB continued their unusual workout scheme.

In early March of 1989, FKNB approved a loan for FWB to purchase the P&J Food Mart referred to above. The loan proposal sheet has been heavily modified at some point to remove provisions related to the need to obtain new appraisals on the food mart, collateral release provisions and the fact that, at one point, the loan was rejected by the L&D Committee. This loan placed FWB and his entities total loans with FKNB at well over $600,000.00. However, in documentation prepared for the transaction by the bank's counsel, the record owners of the property were to be FWB's parents, Fred and Pearl Bramblett (Bramblett Parents) . The Court finds that this is the first occasion on which the Bramblett Parents were to be used as nominees or substitutes for FWB in a loan transaction with FKNB. For whatever reason the property was never transferred to the Bramblett Parents.

Later in March of 1989, FWB was able to sell the property management division of Rose Realty to Shirley Charles, one of Rose Realty's employee's for $75,000.00. FKNB loaned Ms. Charles the funds necessary to purchase this business and secured the loan by taking an assignment of the property management division's business contracts which had an estimated value of $160,000.00. There is no explanation in FKNB's files as to why FWB would sell an asset worth at least $160,000.00 to an employee for $75,000.00. A significant amount of the proceeds of this loan went to replenish funds which FWB had previously diverted from the Rose Realty escrow[4] accounts which he controlled to service FWB's debt with FKNB. Further bank documents show that the vast majority of the remaining loan proceeds went to the Bramblett corporation, the title owner of Rose Realty. Ms. Charles' loan was also guaranteed by FWB.

On March 30, 1989, FKNB entered into what has been termed the $142,000.00 Laundromat loan. The nameless Elizabethtown Laundromat is one of the most curious pieces of real estate in recorded bankruptcy history as it was titled in the name of one party (the Bramblett Parents), operated by another party (James Bramblett), sold to the Sallees by a third party (FWB) in a deal negotiated, as we shall discuss below, primarily by the secured creditors holding the mortgages on the property (FKNB). A bit of history is necessary to explain this Byzantine chain of events.

In early February of 1988, the Bramblett Parents obtained a $375,200.00 loan to purchase the Laundromat. This loan was secured by a first mortgage on the Laundromat, which had been appraised by Banet (in a one

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[4] While FKNB and the debtors argues at length about whether certain Rose Realty accounts were actual technical escrow accounts it is clear as noted earlier that the accounts contained funds owned by parties other than Rose Realty.

page letter) at $469,000.00. On February 25, 1988, the Bramblett parents purchased the Laundromat for $375,200.00 from Jimmy Bramblett and his wife, Lucinda. Approximately one year later, the $142,000.00 Laundromat loan was made to the Bramblett Parents. A copy of the loan proposal is attached hereto as exhibit D to illustrate the rather low standard of review Bramblett loans were subjected to by FKNB. Missing from both the L&D review and the Bramblett Parent's financial statement is the approximate $375,000.00 mortgage the Bramblett Parents owed FKNB. Although the stated purpose of the loan was to provide working capital to the Laundromat, all but $39,000.00 of the loan was used to pay FWB debt service, fund escrow accounts on FWB deals or pay bank fees. Rather conveniently Banet re-appraised this property at $647,000.00 for the $142,000.00 Laundromat loan, an apparently 38% increase in its value in the space of little more than one year. Although FKNB objects to the Sallees' characterization that Logsdon "worked backwards" to determine the loan amount, we find that characterization to be reasonably accurate as Banet's appraisal more closely reflects the appraisal amount needed for the loan, rather than any reflection of economic reality. It is interesting to note that the Bramblett Parents, Jimmy and FWB walked out of the bank with approximately $25,000.00 of the loan proceeds.

Shortly after the $142,000.00 Laundromat loan was made, FWB approached Worth Sallee about purchasing the Laundromat, which was located near the Sallees' convenience store. Worth Sallee testified that he had never liked the people the Laundromat's game room attracted and that he might be interested only if the game room was eliminated and replaced with additional Laundromat equipment and he could have 100% financing on the deal. Shortly thereafter Cooney contacted Sallee to discuss the debt on the Laundromat and FKNB's possible financing of Sallees' acquisition of that business. Cooney and Worth Sallee met several times over the next several days to discuss Sallee's

purchase of the Laundromat. During these meetings Cooney informed Sallee that the bank was eager to yet FWB out of the Laundromat, and that Sallee could purchase the Laundromat from FWB at a good price and that FKNB would fully finance the transaction. Cooney also gave Sallee a pro-forma and a site survey concerning a Laundromat. In his deposition Sallee testified he believed that the pro-forma was prepared for another similar Laundromat FWB intended to build. At trial he testified the pro-forma was of the Laundromat he was planning to purchase. While Sallee's memory of this matter is not clear, the Court finds that it is unimportant whether the pro-forma was represented by Cooney to be for the Laundromat in question or a different Laundromat, as it was clearly provided to Sallee as evidence of the potential profitability of the Laundromat he was planing to purchase and to induce him to purchase that property. The pro-forma and site survey indicated the Laundromat would gross between $152,000.00 arid $200,585.00 per year. Cooney also discussed the possibility of making further loans to Sallee to consolidate his business debt and permit him to purchase the convenience store real estate. The Court finds that Cooney was instrumental in convincing Worth Sallee to purchase the Laundromat and that Worth Sallee reasonably relied upon the pro-forma and site survey provided by FKNB, in making his decision to purchase. While this site survey and pro-forma might not ordinarily be documents upon which a businessman could reasonably rely, the fact that FKNB, the bank proposing to make the loans to Sallee to purchase this property, gave these documents to Sallee to show the value of the property clearly makes Sallees' reliance upon them reasonable.

In making the above findings the Court relies primarily upon the testimony of Worth Sallee, whose testimony we find, with one exception discussed below, to be credible and forthright. Ms. Cooney's testimony while we believe it was honest, can be summed up by saying she has no remaining detailed memory of any of her conversations with

Worth Sallee. Further, her contemporaneous notes of her meetings with Worth Sallee have vanished from FKNB's files. While this Court has not been presented with any evidence that Cooney or any other FKNB or DFC employee intentionally removed or destroyed these documents, the absence of these documents coupled with Ms. Cooney's lack of memory leaves Sallee's testimony unrebutted.

On May 25, 1989, Worth Sallee presented a financial statement to FKNB showing a net worth of $319,739.00. This net worth was inaccurate as demonstrated by FKNB expert, Cate Elsten ("Elsten"). After reviewing the testimony of Elsten and comparing it to the evidence presented by the Sallees, this Court finds that the Sallees actual net worth was $267,200.00. $188,939.00 of this figure represents Worth Sallee's Lowes' stock holdings in his various pension plans. The $52,539.00 difference is attributable to an overstatement of the value of liquid assets of $7,063.00, of the value of undeveloped real estate by $12,500.00, the value of personal property and household furnishings by $20,000.00 and an understatement of trade liabilities by $21,976.00.

After the Sallees' financial statement was submitted to FKNB, the FKNB Loan Committee approved a $575,000.00 loan to the Sallees ("Sallee Loan") May 26, 1989. The Sallees believed the amount of the Sallee Loan represented the entire purchase of the Laundromat. The Sallee Loan was based on an appraisal of the Laundromat of $726,000.00 (provided by the ever present and cooperative Banet) and the delivery of a current P&L statement on the current Laundromat business and a pro-forma statement on the new business. From a review of the bank's files these requirements were apparently satisfied by the Bramblett site survey and pro-forma, as no other similar documents exist in the Sallee loan file. Cooney and Logsdon, her boss, were fairly certain of the approval of the Sallee Loan, as distribution checks were prepared on May 25, 1989 before the loan was officially approved. It is important to note that during this entire process of loan negotiations that FKNB

never revealed to the Sallees that the appraised value of the Laundromat had risen from $469,000.00 in February of 1988, to $647,000.00 in March of 1989 to its current high of $726,000.00[5] as of May 26, 1989, an average monthly increase in value of $17,135.34, or 3.65%, from its initial appraised value. This Court finds that this series of appraisals are, bluntly put, fraudulent, with the values being determined by FKNB loan formula rather than any economic factors. Further, based upon the quality of the appraisals and the math discussed above, this Court finds that Logsdon and Cooney deliberately ignored the clear evidence that these appraisals were inflated appraisals in their rush to keep FWB afloat by making new loans to FWB and other related parties and assisting him in obtaining new purchasers for his over appraised projects, such as the Laundromat owned by this parents.

On May 31, 1989 the sale of the Laundromat and the Sallees' loans closed. These closings were anything but uneventful. First, the loan was set up as a construction draw note and disclosed the wrong finance charge. Second, the Sallees were presented with one of the strangest agreements this Court has ever reviewed (see attached exhibit E) which states that the Sallees will leave $100,000.00 from Worth Sallee's ESOP plan with FKNB in the form of either an IRA or certificate of deposit until the Sallee Loan is paid in full and further granted the bank "set off rights" against the $100,000.00 ("Stock Agreement") . Sallee was granted the option to chose the form the $100,000.00 would take and the evidence clearly shows that he chose to deposit the $100,000.00 in an IRA. Unfortunately, Sallee's wishes were not fulfilled and the IRA was never established. We will discuss the ultimate fate of Worth Sallee's

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[5] Indeed there was testimony that Cooney originally told Sallee the Laundromat had appraised for $750,000.00, although no such appraisal exists and Cooney states this could have arisen from a verbal appraisal by Banet prior to his written appraisal.

ESOP stock later in this opinion. At the time of the closing, Cooney informed the Sallees that Worth's retirement could not be touched by the bank and based upon these assurances and his quick review of the agreement the Sallees signed this document. Although FKNB argues that the Sallees knew they were pledging the proceeds of Worth's retirement plan when they executed the Stock Agreement, this argument is not credible. Indeed this Court, which has some small experience in interpreting loan agreements, has had great difficulty making sense of this agreement.

Finally, the Sallees were presented with a real estate purchase contract between themselves and the Bramblett Parents (until that time the Sallees thought FWB was the owner of the Laundromat) which strangely set a purchase price of $725,000.00, to be financed by the Sallee Loan of $575,000.00 and a $150,000.00 note payable by the Sallees to FWB! Not surprisingly the Sallees were dumbfounded by the price and terms. Cooney told the Sallees the price was inserted for bank purposes only. The Sallees refused to sign the $150,000.00 note and attempted to delete all references to the $150,000.00 note in the purchase contract, but missed a reference on the first page of the purchase contract. With the unsigned note to FWB, the altered sale contract (the changes in the sales contract had not been agreed to by the Bramblett Parents who signed their documents first and then left the bank) as well as the other documents which were properly executed, Cooney completed the closing and had the money disbursed to payoff the Bramblett Parents' note to FKNB. This transaction freed up the Bramblett Parents' credit with FKNB for the last, and most bizarre step of the FWB workout.

After the Laundromat closing, Sallee Informed Hardin County that he would shortly be able to pay off his obligation to them as soon as FKNB put together a loan package to consolidate his commercial debt ("Package Loan"). For the next several months this purported Package Loan was often discussed by Worth Sallee and Logsdon.

However, one more loan was made by Cooney and Logsdon in an effort to service FWB's debt. In early June of 1989, FWB entered into a contract to buy the Keystone Apartments ("Apartments") from Robert and Kyong Kipilla (who held a contract for deed in the apartments) and John and Lydia Drexler (the fee simple owners) for $545,000.00. Initially FWB was to be the borrower, but for whatever reason it was determined that the Bramblett Parents would be more acceptable borrowers. On June 15, 1989, a loan to the Bramblett Parents, in the amount of $669,600.00 for the purchase of the Apartments, was approved by FKNB. The amount of the loan was based upon: 1) yet another Banet appraisal which stated that the fair market value of the Apartments was $837,000.00; 2) the pledging of a $50,000.00 CD as additional security for the loan; and 3) the very recently improved balance sheet of the Bramblett Parents.

Given the purchase price of the Apartments, which Cooney and Logsdon clearly had knowledge of based upon the documentation in the FKNB loan files, this appraisal by Banet would be humorous except for the huge losses it caused for FKNB and indirectly DFC. Needless to say this loan violated a large number of internal bank lending policies.

On June 21, 1989, the Apartment purchase and loan were closed by FKNB's attorney who disbursed the loan proceeds from their firm's escrow account. The purchase price of $545,000.00 was paid to the sellers, $50,000.00 was used to purchase the CD to be held as additional collateral and the balance of approximately $75,000.00 was used to either service FWB's debt, make required payments on FWB's shopping center deal with Booher or replenish escrow accounts.

In July of 1989, Lowes distributed Worth Sallee's ESOP stock. There is massively conflicting evidence as to whether Worth Sallee or FKNB initially received the stock. The Lowes' ESOP plan correspondence indicates the stock was sent to FKNB on or about July 25, 1989, while correspon-

dence from Wachovia Bank & Trust Co., the entity administrating the ESOP plan, shows Worth Sallee received the stock. While the parties devoted a large amount of energy on this issue the Court finds it to be largely irrelevant since, as of September 1, 1989, the ESOP stock was delivered to Cooney who gave Worth Sallee a "safekeeping receipt" for the stock. This receipt however also indicated, in small boiler plate language, that the distributed stock was also security for the gas inventory loan. This Court accepts Sallee's testimony that the typewritten notation of this stock being security for the gas inventory loan was not present when he executed the document.

In August of 1989, the final renovation of the Laundromat was completed and Sallee informed FKNB of that fact and inquired concerning the status of his Package Loan.

FKNB hotly disputes that it ever agreed, through Logsdon and Cooney, to make a long term, $1,200,000.00+ commercial loan to the Sallees to refinance their loans with FKNB, Hardin County and permit them to purchase the real property where the convenience store was located. We reject this, finding that Logsdon and Cooney did in fact orally promise Worth Sallee to make the "Package Loan" to the Sallees. Cooney, we find, discussed the possibility of a Package Loan during the negotiations for the Sallee Loan and committed to Worth Sallee that FKNB would at least provide long term refinancing of the Sallee Loan, as the original loan term was less than one year. As the Sallees continued to work with FKNB, Logsdon assured Sallees that he would put together a more comprehensive refinancing package. This Package Loan although never set forth in full detail, would have refinanced all of the Sallees' commercial debt into a single loan through FKNB. It also would have been, by far, the worst loan FKNB ever made, had it ever materialized. From our review of the evidence it is clear that the Sallees could have never made any current payments on a loan this size from the revenues generated by the Laundromat and convenience store.

Further, while this Court agrees with FKNB that such a loan would be impossible for FKNB to make by itself under the banks established internal lending limits, we specifically hold from our review of the FKNB loans discussed above that FKNB: 1) rarely if ever paid any attention to its own lending policies; 2) routinely failed to follow sound lending practices in general; and 3) apparently never reviewed or verified any of the financial information which its borrowers presented in their loan applications. After closely examining the FKNB commercial lending practices, this Court would not he surprised by the terms of any commercial loan. The banks own expert, Dr. Mullineaux, was highly critical of FKNB's commercial lending practices.

Further, there is no evidence that Logsdon could not have structured such a loan package through loan participation. Given Logsdon's ties with other Local Banks it is not unreasonable to believe that such a loan could have been made through FKNB.

Finally, even if this loan package could not be made by FKNB, the Sallees had no way to know that Cooney and Logsdon were promising the impossible. We find, based upon all the evidence, that Worth Sallee reasonably relied upon Logsdon's and Cooney's promises of a Package Loan in his dealings with FKNB. We also hold Cooney and Logsdon's rather weak denials, that such a commitment was not made, to be unpersuasive. At this point we also wish to address the matter of the 1989 Liberty National Bank loan application. FKNB argues that this document shows that Sallee was never promised a "Package Loan" due to his request for a loan from Liberty. Sallee, on the other hand believes the document is a total forgery, manufactured by the bank from a piece of paper he signed in blank for Logsdon. This Court rejects both explanations and finds that whatever this document may be, it has no relevance to this case.

Despite the Sallees' failure to make the August 29, 1989 interest payment due on the Sallee Loan and their

increasing cash flow problems, FKNB rebooked Sallees' loans into the renewed loans. Although FKNB had agreed to put the Laundromat on long term financing, the renewed loans were short term loans, just like their predecessors.

In early September of 1989, partly as a result of the critical OCC and DFC loan reviews and partly because Logsdon was preparing to be promoted to president of FKNB upon the retirement of Col. Pratt, FKNB hired a new senior commercial lending officer, Carroll Yates ("Yates") . In light of the nature of this opinion, the Court wishes to specifically state that Carroll Yates was not involved in any of the unusual lending practices discussed herein, except that he attempted to establish reasonable lending standards for FKNB's commercial loans, which greatly helped expose the previously made problem loans. We found Yates to be an honest, forthright and highly credible witness. Also at this time FKNB, at the urging of DFC, began to reduce its commercial lending efforts.

However, at the same time FKNB was hiring Yates, Worth Sallee began to have serious problems with his other lender, Hardin County. Hardin County had not received its ESOP stock which Worth Sallee had assigned to it under the terms of his loan agreement with Hardin County and was inquiring as to when the stock would be delivered. The reason, of course, was that the stock had been delivered to FKNB under Sallees' agreement with FKNB concerning the Sallee Loan. While Worth Sallee may not have fully understood the consequences of his assignment of his ESOP stock to either FKNB or Hardin County, he did understand that he had separately agreed to put his ESOP stock in each bank until their loans were paid off. He therefore took the unwise and improper step of misleading Hardin County as to the actual location of the ESOP stock by telling Hardin County to contact Lowes to determine the stock whereabouts, when as of September 1, 1989, he knew the stock was in FKNB.

The Court is highly troubled both by Sallee's actions regarding Hardin County's search for the ESOP stock and his great reluctance to admit the obvious, i.e. that he failed to tell Hardin County about the location of the ESOP stock in order to buy time for the promised Package Loan at FKNB to be finalized. However, while this somewhat lessens this Court's opinion of Worth Sallee's believability and made the Court more carefully review his testimony, it did not destroy his credibility as a witness.

On September 15, 1989, Hardin County learned of the location of the ESOP stock, and were properly outraged. Hardin County sent Sallee a demand letter on September 16, 1989 which required Sallee to either pay his loans to Hardin County or provide "sufficient guarantee" of such payment by September 19, 1989 or it would take legal action, including possible criminal action against the Sallees. Needless to say, Worth Sallee was quite upset with this development and met with Hardin County officials, who extended the deadline for a few days. Worth Sallee then met with Logsdon and Cooney. Logsdon was angry with Hardin County's demands and strongly urged Sallee to sue Hardin County, presumably for their "unreasonable" collection activities. He also informed Sallee he would work with Sallee to raise the money to pay off Hardin County, although he was still unable to complete the Package Loan.

Initially Logsdon contacted Charlie Watts, then Executive Vice President of Leitchfield Deposit Bank ("Leitchfield") about making a quick, short term loan to Sallee to payoff Hardin County. Watts was unable to complete any loan transaction for at least 10 days. After informing Logsdon of this development, Logsdon agreed to loan the Sallees $50,000.00, which combined with other borrowing by the Salleès and the liquidation of most of their remaining assets, except for their ESOP stock and their business, provided them with enough to pay off Hardin County. As was typical of FKNB's lending practices, the $50,000.00 loan was approved as a short term unsecured

working capital loan "based upon Sallees' net worth". No mention of the true reason for the loan was ever mentioned in the loan proposal summary presented to the Loan and Discount Committee. However, the loan summary did disclose that this loan would be repaid from the sale of Sallee's ESOP stock. Sallee was informed by Logsdon that his stock would be sold and Sallee consented to the sale of stock, upon Logsdon's guarantee that Sallee's IRA would be replenished after Logsdon closed the Package Loan. Logsdon failed to tell Sallee that no IRA had ever been set up for him at FKNB.

Logsdon also discussed with Watts the possibility that Leitchfield could make a working capital loan to Sallee for the operation of his convenience store as the pay off of Hardin County had eliminated the Sallees' source of working capital. Logsdon told Watts that the Sallees' convenience store was profitable and provided Watts, through Cooney, a copy of Sallees' financial statement which disclosed that a $190,000.00 IRA account existed at FKNB. While we find Sallee reasonably believed he owned such an account, it is undisputed that Logsdon and Cooney knew the IRA did riot exist and failed to inform Watts of that fact.

On or about September 29, 1989, Sallee's ESOP stock was sold and the proceeds check mailed to the Sallees' home. In early October Logsdon found out the proceeds check had been sent to the Sallees and he contacted Worth Sallee who immediately delivered the proceeds check to FKNB. After obtaining the proceeds check FKNB used $50,143.83 to payoff the $50,000.00 note owed by the Sallees and applied an additional $16,985.34 to interest on the Sallee Loan. The balance of the proceeds were used to purchase a certificate of deposit, not placed in an IRA as had been represented to Worth Sallee by Logsdon, which was held as collateral for the Sallee Loan.

At the same time as FKNB was using the proceeds of Worth Sallee's ESOP stock to reduce his debts to FKNB, Yates was about to find out some of FWB's faked transac-

tions. On or about September 28, 1989 Yates discovered that FWB, in a transaction not previously discussed, had executed two separate purchase agreements, one which provided FWB would provide part of the financing for the transaction and a higher sale price and a second contract which set forth the true sale price. Yates immediately informed DFC about this fraud. Yates also began to refuse to rebook or extend loans without the payment of current interest. This very sound banking practice caused FKNB commercial loan delinquencies to rise dramatically.

As a result of this new trend, DFC and Dickinson began to more closely monitor FKNB's commercial lending activities. In November of 1989 FKNB charged off an additional $440,575.00 for bad loans. This charge was the first of many for FKNB which would ultimately write off approximately $5,700,000 in bad loans in 1989 and 1990.

Unfortunately for FKNB, Yates was not in total control of all commercial lending. On November 22, 1989, FKNB renewed FWB's $102,500.00 strip shopping center loan and continued to take as a security interest an assignment of the Smith now worthless purchase contract. This is particularly strange in that the bank financed the sale of this shopping center to Booher several months earlier.

Throughout the end of 1989 both Worth Sallee and Watts continued to discuss the status of the Sallee package loan with Logsdon. Logsdon told Sallee that there were problems at the bank but when he was made President he would be able to make the Package Loan in early 1990. Logsdon also told Watts that he could "take back" Sallee's loans as soon as he became FKNB's President. Sallee's testimony is partially supported by Yates who remembered Sallee requesting that the Laundromat loan be restructured, as well as complaining that FWB may have cheated him, although he had no memory of any discussions about the Package Loan. Logsdon told Watts that he needed to have some of the loan out of FKNB. Logsdon then requested that Leitchfield make Sallee a $275,000.00 which virtually eliminated Sallee's convenience store loan with FKNB.

Sallee was only indirectly involved in the $275,000.00 Leitchfield loan. Although FKNB makes much of the fact that a corporation owned by Watts ultimately obtained ownership of the Sallee's convenience store after it was sold in the Sallee bankruptcy, we find that this somewhat unusual fact has no bearing on the testimony of Watts which we find to be truthful and accurate.

On December 17, 1989 FWB found an individual, Pat Burnfin, who entered into a contract for deed of the P&J food store owed by FWB and heavily mortgaged to FKNB. This transaction was not a direct part of the FKNB work-out as FKNB did not provide any financing for this transaction. Indeed Logsdon apparently had no knowledge of this transaction as he had other problems to deal with at this time.

On the same day as the closing of the Burnfin contract for deed, Dickinson and other officials arrived at DFC for meetings. Dickinson asked to do a visual inspection of his commercial loan collateral. Unlike Logsdon and Cooney, Dickinson had some reasonable understanding of the general value of commercial real estate and became what can be best described as "thoroughly sickened" by the state of the FKNB collateral. This Court finds Dickinson's reaction to be both reasonable and highly perceptive.

On December 18, 1989 Dickinson had the FKNB board terminate all commercial lending, including renewals or extensions of existing loans, without prior DFC approval. This action in effect ended any chance Logsdon had to make good on his (and FKNB's) promise of the package loan. Logsdon did not inform either Leitchfield or Sallee about this new policy.

On December 29, 1989 Sallee entered into a 48 day extension of the Laundromat loan. This extension is somewhat strange in that on the same day Logsdon placed a memo in the Sallee's file that after Leitchfield made a $275,000.00 loan to Sallee, $50,000.00 of the proceeds of the loan would be applied to the Sallee Loan and $65,000.00

would be used to pay off the Sallee's FKNB loan on the convenience store. The memo stated that the balance due on the Laundromat would be placed on "monthly payments" of an undisclosed amount. This memo conflicts with Logsdon's representation to Worth Sallee that he was extending the Laundromat loan until April or May of 1990, when he could put together the Sallee's Package Loan. Sallee signed this extension agreement based upon Logsdon's representation concerning the Package Loan.

In January of 1990, James Thompson, ("Thompson") who is the officer of DFC that "cleans up" problem loans in DFC banks, was sent to FKNB. Much as with Dickinson, this Court was impressed with Thompson's knowledge about banking and honesty in his testimony. Thompson was sent to FKNB by Dickinson to investigate Logsdon, Cooney and the commercial loan portfolio of FKNB. Although the parties devoted a great deal of time to whether Thompson was first at the bank in 1989 or 1990, this Court believes Thompson's testimony that he first came to FKNB in early January of 1990.

Although Thompson's contemporaneous notes of his investigation have been removed or lost from FKNB and DFC files, it is clear that he and DFC were suspicious of Logsdon and Cooney. Further it is clear that Thompson found FKNB's commercial lending operation to be a total disaster. Shortly after Thompson's arrival, FKNB moved to clean-up the problem.

On January 10, 1990 Cooney was terminated by FKNB. Sometime thereafter Yates was also terminated. All parties, including Thompson, agreed that Yates' termination was a mistake, since Yates had no involvement in the making of the problem loans and in fact, had been the officer who originally uncovered the problem. For reasons beyond the Court's understanding, FKNB first promoted Logsdon to President of the bank in January 1990, and then several weeks after his elevation, fired him. Further, another appraiser, Rick Baumgardner was hired to review Banet's appraisals. Not surprisingly Baumgardner found the Banet appraisals to be unprofessional and highly inflated.

Sometime in January of 1990, Thompson met with FWB and his father who discussed in detail circumstances of the Keystone Loan and the Bramblett's rapidly deteriorating financial situation. FWB asked for an additional loan to fix up the property so he could raise rents. Not surprisingly Thompson and FKNB turned this request down.

On January 25, 1990 Sallee had his initial meeting with Thompson. Sallee and Thompson discussed Sallee's financial situation and informed Thompson the actual purchase price of the Laundromat was $575,000.00. Thompson attempted to gain some financial information about Sallee (apparently taking the healthy precaution of verifying any financial information in FKNB's files) . Thompson's discussions with Worth Sallee continued for several weeks as Thompson worked to set all the information he could about the Sallee Loan. Thompson had two purposes in this line of inquiry. First, Thompson was attempting to determine whether FKNB could legitimately refinance the Sallee Loan. For several months he worked with Sallee in an attempt to restructure the Laundromat debt. However by mid June of 1990 these negotiations about a straight refinancing had broken down.

Thompson's second objective in these discussions was to determine whether any criminal fraud was committed by the Sallees, Brambletts or any other party to the Sallee Loan on the Laundromat. From this Court's view, Thompson had good cause to be suspicious of the Sallees. While it is puzzling why neither Thompson, nor anyone else at DFC ever interviewed Cooney or Logsdon about these loans, we find that on a whole that Thompson did an adequate job of investigating the Sallee Loan given the records and other information he had to work with.

Thompson also investigated the various Bramblett loans with FKNB as well as other commercial loans at FKNB, both to see if the loans could he salvaged or whether there was possible criminal activity. It is important to note that during this time frame, the full horrors of the nation wide S&L collapse were beginning to emerge.

On June 21, 1990, Thompson submitted a criminal referral against Worth and Sandra Sallee concerning the Sallee Loan on the Laundromat. The Sallee have devoted an enormous amount of time and effort to prove FKNB committed tort of outrage by filing this criminal referral when it had knowledge, through its officers, Logsdon and Cooney, that the criminal charges were unwarranted. However, this Court adds that FKNB and Thompson acted in good faith, as that term is defined by 12 C.F.R. §21.11, in the filing of the criminal referral. While corporate entities such as FKNB are imputed with the knowledge of their officers, including Logsdon and Cooney, here the officers at DFC and FKNB which prepared the criminal referral had no actual knowledge of the Sallee's innocence and had conducted a reasonable investigation before the filing of the criminal referrals. FKNB would ultimately make criminal referrals against the Bramblett's parents and Cooney and Logsdon concerning other loans related to FWB.

In the summer of 1990, FKNB's commenced litigation against the Brambletts on their various notes and ultimately Jimmy, the Bramblett Parents, Booher and the Sallees filed for protection under the bankruptcy code. FWB has not yet bothered to file bankruptcy. This adversary proceeding after an interesting, but now unimportant procedural path, ultimately arrived in this Court, where after over four years of discovery it was tried in a multi-part 38 day long proceeding.

This Court notes that throughout the litigation of this adversary proceeding, both FKNB and DFC have fought most, if not all of the bankruptcy estate's attempts at discovery. Although some of DFC and FKNB's resistance to discovery have arisen from the extremely expansive discovery requests of the bankruptcy estate, which demanded in essence, almost every document generated by FKNB even remotely connected with the matters discussed above, the vast majority of the defendants resistance was due to a hard nosed trial strategy. Both FKNB and DFC constantly took the most restrictive view, of what was required to

comply with the estate's discovery requests, that was ethically and legally permissible. This strategy, coupled with the highly disorganized state of FKNB records, caused the bankruptcy estate to devote a great deal of unnecessary time and expense to the discovery process. Indeed, this Court reviewed more contested discovery disputes in this case than it had in all remaining cases it has handled in the last five years.

However, as stated earlier, the actions taken by both DFC and FKNB concerning discovery were in fact legal and despite the bankruptcy estate's numerous arguments to the contrary, we find no evidence of spoilation of evidence by FKNB. This Court cannot state that these discovery tactics were a model of professionalism, but they were clearly not illegal.

Summary of Factual Findings

After making the above factual findings in great and exhaustive detail, (except for our factual findings concerning damages which will be set forth later in this opinion) this Court feels a brief overview of these findings is necessary to fully understand our holding.

In the mid 1980's, FKNB though Logsdon and later Cooney made a series of loans to FWB and various entities controlled by him to finance a wide variety of real estate projects. These loans were poorly documented, loosely collateralized and made on financial information that would be inadequate for a $500.00 personal loan. By 1988, FKNB's easy lending policy and FWB's incompetence had resulted in FKNB having several hundred thousand dollars of bad loans. Rather than face the consequences of his slipshod lending practices, Logsdon decided to see if he could keep from taking the loss by making new loans to FWB, his relatives and related entities and using excess loan proceeds to keep FWB's old debt current. A further element of this workout was for FKNB to find, for lack of a better term, new borrowers, to purchase FWB's over mortgaged properties and take over FWB's debt. Logsdon, we find, hoped these new borrowers would be better able to pay

FWB's debt and would keep the bank from suffering high losses on these loans.

Throughout 1988 and 1989 FWB looked for new borrowers and generally when they were found, Logsdon arranged for FKNB to finance their purchases of FWB's, Jimmy's, the Bramblett Parents' or related entities' assets. Logsdon and FWB's task was made much simpler by Banet, who would, and could, find any real estate had the value needed to support a loan to take out the previous loans. Ultimately, FWB decided to convince Worth Sallee to purchase the Laundromat to free up his parents credit and prevent their loans on the Laundromat from going bad.

First Cooney and, then Logsdon, worked with FWB in his effort to get the Sallees to purchase the Laundromat, by assuring Sallee he was getting a good deal, providing 100% financing and agreeing to future easy credit to help Sallee put together the type of business he had always wanted. However, Logsdon and Cooney made these loans knowing: 1) that the underlying property's appraised valuation had radically inflated from $469,000.00 in February of 1988 to the $726,000.00 in May of 1989; 2) and that the current owners and operators of the Laundromat were not able to service the debt then on the Laundromat; 3) that Sallee was actually relying upon Logsdon and Cooney's representations in making his decision to purchase the Laundromat. However the main reason Logsdon was so eager to make this loan to Sallee was not an altruistic desire to help his fellow man, but rather the existence of Sallee's Lowes Stock, which Logsdon worked diligently to liquidate to help pay off FKNB.

Throughout the late Summer and early Fall of 1989 Logsdon worked feverishly to keep Sallee, FWB and other related loans from becoming delinquent. As part of these efforts Logsdon convinced Sallee to sell his Lowes ESOP stock to help pay off a short term loan. Sallee only agreed to this course of action when Logsdon agreed to replenish Sallee's IRA (into which the Lowes stock was going to be placed) with funds from the promised package loan. Unfor-

tunately for Sallee, Logsdon never established or even attempted to establish Sallee's IRA and ultimately, Sallee's retirement funds were lost .

However, with the OCC and DFC loan reviews and Yates careful and diligent review of FKNB loans, Logsdon's complex house of cards collapsed. DFC and its owner correctly terminated the commercial lending at FKNB, after reviewing what passed as collateral for FKNB's commercial loans in late December of 1989. Logsdon failed to inform Sallee of this critical policy change, apparently in the vain hope he would be able to somehow reverse it when he became FKNB's President. This was not to be, as DFC's personnel quickly descended upon the bank, discovered the true magnitude of the problem and fired Cooney, Logsdon and unfortunately Yates, who had had nothing to do with the lending problems.

After January of 1990 DFC had direct control of FKNB and began to deal with all of FKNB's troubled commercial loans including the Sallee's Laundromat loan and the mass of Bramblett and Bramblett related loans. Unlike the previous workout efforts employed by FKNB, the new workout efforts were tough, but reasonable and fair. Indeed, other than their failure to more carefully monitor FKNB, we can find little fault with the actions of DFC and its owner. Unfortunately for the Sallees, the massive amount of debt on the Laundromat, coupled with the serious questions surrounding the entire Laundromat transaction made any restructuring of their finances impossible. Further based upon a reasonable, if not through investigation, Thompson and FKNB reached the erroneous conclusion that the Sallees may have participated with FWB in defrauding FKNB and filed a criminal referral against Sallee. This referral, although meritless, was clearly made in good faith.

Finally the Sallees were forced to seek the protection of the bankruptcy code and ultimately brought their claims against FKNB to this forum. While FKNB certainly did not comply with the spirit of open discovery and took an extremely narrow view of what evidence was relevant to

this proceeding, we find that FKNB did act within its legal rights during the discovery process.

Legal Analysis

In their pleadings, the Sallees assert a number of claims against FKNB and/or DFC including:

1. Breach of fiduciary duty
2. Fraud
3. Breach of contract
4. Spoilation of evidence
5. Interference with a contractual relationship; and
6. Improper criminal referral of the Sallees (Tort of Outrage)

We begin our discussion of these claims by first addressing the most important underlying legal issue in this case. i.e. what was the nature of the relationship between FKNB and the Sallees. We shall then discuss each of the Sallees' claims.

A) Debtor-Creditor or Fiduciary Relationship?

Initially, this Court must determine whether the relationship between the Sallees and FKNB was that of a creditor to its debtor, Forsythe v. BancBoston Mortgage Corp., 135 F.3d 1069 (6th Cir. 1998) (ordinary mortgage relationship does not create fiduciary relationship between bank and borrower), or a fiduciary relationship which imposes a much higher duty upon FKNB in its dealings with the Sallees. See Steelvest, Inc. v. Scansteel Services, 807 S.W.2d 476 (Ky. 1991); Henkin, Inc. v. Berea Bank and Trust Co., 566 S.W.2d 420 (Ky. App. 1978); Lappas v. Barker, 375 S.W. 2d 248 (Ky. 1963). As a general rule, the relationship between a borrower and a lending bank is merely that of a debtor and creditor. Forsythe, 135 F.3d at 1076; Steelvest, 807 S.W.2d at 485. However as noted in Henkin:

> The question of whether a bank stands in a fiduciary capacity with respect to confidential relations with its customers has arisen in other states. In Warsofsky v. Sherman, 326 Mass. 290, 93 N.E.2d 612 (1950) a member of the bank's loan committee learned of an offer to

sell real property from an applicant for a loan who intended to use the loan proceeds to purchase the property. The member of the loan committee took advantage of the information and purchased the property for himself. In a well reasoned opinion the Massachusetts court stated:

(3-5) Doubtless, there are many familiar and well recognized forms of fiduciary relationships such as attorney and client, trustee and beneficiary, physician and patient, business partners, promoters or directors and a corporation, and employer and employee. See Hawkes v. Lackey, 207 Mass. 424, 433, 93 N.E. 828; Yamins v. Zeitz, 322 Mass. 268, 272, 76 N.E.2d 769. The relationship is not confined, however, to these and similar situations, for the circumstances which may create a fiduciary relationship are so varied that it would be unwise to attempt the formulation of any comprehensive definition that could be uniformly applied in every case. See Scott on Trusts, § 462; Pomeroy, Eq.Jur., 5th Ed., § 956a. There is jurisdiction in equity to prevent, by means of the remedial device of a constructive trust, unjust enrichment arising out of a breach of a fiduciary relation(ship). The existence of the relationship in any particular case is to be determined by the facts established. It was said by Lord Chelmsford in Tate v. Williamson L.R. 2 Ch. 55, 61, "Wherever two persons stand in such a relation that, while it continues, confidence is necessarily reposed by one, and the influence which naturally grows out of that confidence is possessed by the other, and this confidence is abused, or the influence is exerted to obtain an advantage at the expense of the confiding party, the person so availing himself of his position will not be permitted to retain the advantage, although the transaction could not have been impeached if no such confidential relation had existed." That statement has been frequently cited with approval by this court.

Here, under the extreme facts of this case, we find that Sallee placed misguided, but reasonable, faith and confidence in FKNB through Cooney and Logsdon during the entire course of the Laundromat transaction and the other

FKNB loans made to the Sallees thereafter. Cooney and Logsdon did not merely respond to the Sallees' loan request but actively assisted Sallee in arranging the purchase of the Laundromat. Cooney represented to Sallee that paying off FKNB's debt was FWB's primary concern and that therefore he could work with FKNB, as opposed to FWB, whom he greatly distrusted in arranging the details of the sale. FKNB also presented Sallee with documents from loan files on the previous Laundromat loans purporting to be evidence of its value, repeatedly assured Sallee that his pension assets were safe, negotiated financing for Sallee with third party lenders and promised additional financing to permit Sallee to consolidate his debts. In fact Logsdon and Cooney did everything they could to lull Sallee into a false sense of security concerning his relationship with FKNB and induce him to both purchase the Laundromat, blindly entrust his pension assets to FKNB and continue to go deeper in debt in an effort to keep his hopeless loans from going into default. From the evidence presented in this case, both Logsdon and Cooney abandoned any pretext of being mere creditors of Sallee when they actively assisted the Brambletts sale of the Laundromat to the Sallees, thereby ridding FKNB of a bad loan to shaky borrowers while obtaining the Sallees' assets as collateral. See Steelvest 807 S.W.2d at 486. We therefore hold that the evidence clearly and convincingly establishes that a fiduciary duty arose in this case between FKNB and the Sallees.

We respectfully reject the testimony of FKNB's expert that no fiduciary duty existed between the Sallees and FKNB. The difference between FKNB's expert's conclusion and this Court's findings comes from the fact that we found that the Sallee Loan was an element of the overall FWB workout, while, FKNB's expert's opinion was based in large part upon his factual conclusion that no such workout existed.

B) Breach of Fiduciary Duty

Having determined the nature of the FKNB/Sallee relationship we now must determine what duties a fiduciary

owes under Kentucky law. As stated in the Sixth Circuit in the case of Innes v. Howell Corp., 76 F.3d 702, 715 (6th Cir. 1996):

> Kentucky case law states explicitly that the fiduciary "owes the duty of good faith and full disclosure of the circumstances.... '[T]he disclosure to be effective must lay bare the truth, without ambiguity or reservation, in all of its stark significance.' " Aero Drapery of Kentucky, Inc. v. Engdahl, 507 S.W.2d 166, 169 (Ky. 1974) (quoting Wendt v. Fischer, 243 N.Y. 439, 154 N.E. 303, 304 (1926)) (emphasis added); see also DSG Corp. v. Anderson, 754 F.2d 678, 682 (6th Cir. 1985) (relying on Aero Drapery to find "full disclosure" obligation of fiduciary under Kentucky law).

Id. Although other fiduciary duties may exist under Kentucky law, it is clear that the two most important fiduciary duties are good faith and full disclosure on the part of the fiduciary to those to whom he owes his fiduciary duties.

In the leading case of Steelvest, Inc. v. ScanSteel Service Ctr., 807 S.W. 2d 476 (Ky. 1991) the Kentucky Supreme Court states that: "services to borrowers and pledgers may support a finding that a bank in taking a borrower's note and collateral, falls under a fiduciary duty to disclose material facts effecting the loan transaction" Id. Here, FKNB failed to disclose 4 major sets of material facts "effecting the loan" to the Sallees by failing to:

1) disclose to the Sallees' the appraisal history of the Laundromat;

2) inform the Sallees that this Laundromat was being sold as part of a workout program for the financially troubled Brambletts;

3) clearly tell the Sallees that Worth Sallee's ESOP stock, or any proceeds thereof, would never be placed in an IRA, but would be held by FKNB as collateral for the Sallee Loan; and

4) make full and accurate disclosures about FKNB's actual intent and ability to refinance the short term Sallee Loan.

We wish to note however, that this finding does not mean that lenders, which finance purchase of assets by one of their borrowers from another one of their borrowers become fiduciaries of either borrower. Only in extreme cases such as here, where the evidence clearly shows that FKNB actively promoted and participated in the sale of the Laundromat, by the Bramblett Parents to the Sallees, at an inflated price or the Steelvest, or Henkin, cases discussed above could such a finding be made. See Forsythe v. BancBoston Mortgage Corp., 135 F.3d 1069 (6th Cir. 1998) (bank which negligently handled home mortgage account was not a fiduciary of borrower and was not liable for consequential damages).

C) Fraud

The standard of what constitutes fraud is set forth in the venerable case of McGuffin v. Smith, 286 S.W. 884 (Ky. App. 1926) where the Court of Appeals, then Kentucky's highest court held:

> The general rule is that to constitute actionable "fraud" it must appear: (1) That defendant made a material representation; (2) that it was false; (3) that when he made it he knew that it was false, or made it recklessly, without any knowledge of its truth, and as a positive assertion; (4) that he made it with the intention that it should be acted upon by plaintiff; (5) that plaintiff acted in reliance upon it; and (6) that he thereby suffered injury.

Id. at 886, citing, Baker v. McDonald, 185 Ky. 470, 215 S. W. 292 (1919); Hicks v. Wallace, 190 Ky. 287 227 S. W. 293 (1921); and Crescent Grocery Co. v. Vick, 194 Ky. 727, 240 S. W. 388 (1922). The party asserting that fraud occurred has the burden of proving each element of the McGuffin test by clear and convincing evidence. Miller's Bottled Gas, Inc. v Borg-Warner Corp., 955 F.2d 1043 (6th Cir. 1993).

In the present case, we find that in addition to violating its fiduciary duty to the Sallees, as discussed above, FKNB also defrauded the Sallees by: 1) providing the Sallees with the misleading pro-forma and site survey in-

formation in relationship to the Laundromat transaction while Cooney and Logsdon knew, or should have known, that Banet's appraisals of the Laundromat were inflated; and 2) misrepresenting the fact that FKNB was taking a security interest in Worth Sallee's ESOP stock, and the proceeds thereof, rather than placing the stock in an IRA as Logsdon had agreed to do for Worth Sallee. However, we also find that FKNB did not defraud the Sallees concerning the promises of future financing as the evidence does not clearly demonstrate that at the time Cooney and Logsdon made their promises of future financing, they were unwilling or absolutely unable to make the promised loans. See generally In re Todd, 34 B.R. 633 (Bkrtcy. W.D. Ky. 1983).

As noted in our factual findings above, the Sallees have proven, by clear and convincing evidence, each element of fraud under McGuffin concerning the false representations concerning Worth Sallee's ESOP stock.

In particular we reject FKNB's claim that it made no misrepresentations concerning its intent as to the ESOP stock, due to Sallee's execution of the Stock Agreement. The Stock Agreement was, in FKNB's words, an inartfully drawn security agreement. While it is true that the stock agreement can be read to grant FKNB the right to place up to $100,000.00 of the proceeds of the ESOP stock in a CD as security for the Sallee Loan, this is irrelevant since both Logsdon and Cooney repeatedly assured Sallee that his retirement would be safe and that his ESOP stock, or later the proceeds thereof, would be placed in an IRA. In the case of Hanson the borrower executed loan documents which clearly and specifically gave the bank the right to take all the actions which it took during the course of the lending relationship. However, the borrower in Hanson was found not to be bound by the loan documents as the Court found the bank had misrepresented their contents to the borrower and urged the borrower not to read the documents. Here, we find Sallee exercised ordinary care in relying upon FKNB's representation, made through Logsdon,

and his quick review of the hopelessly confusing stock agreement.

D) Breach of Contract

We also hold, based on the overwhelming weight of the evidence, that FKNB, through Logsdon and Cooney, agreed to refinance the Sallees' commercial debt, through the Package Loan discussed in our factual findings above. We further find that the bank breached this agreement by refusing to actually make the Package Loan. However, as discussed below, we hold that the Sallees' suffered no damages by FKNB's failure to make the Package Loan, because the Sallees could not have possibly made the interest payments which would have been required to service a 1.2+ million dollar debt with the revenues from a overpriced Laundromat and somewhat unsuccessful convenience store.

E) Spoilation of Evidence

Perhaps the most serious allegation made by the Sallees in this case is that FKNB and DFC officials deliberately destroyed a wide variety of documents which would have been evidence in this case and attempted to conceal evidence through the improper redaction of the August 1990 Board minutes. While there is some question as to whether a party can assert a separate cause of action for spoilation of evidence, Mansanto Co. v. Reed, 950 S.W.2d 811 (Ky. 1997) it is clear that courts have broad power to impose harsh sanctions on any party to litigation that would tamper with evidence. See Thurston v. Borden Waste-Away Service, Inc., 1998 WL 456441 (N.D. Ind. 1988); Brady v. U.S., 877 F.Supp. 444 (C.D. Ill. 1994).

However, while we have found that certain relevant documents are missing from FKNB files and that the defendants were somewhat less than eager to provide the bankruptcy estate with discovery, we have also found that the defendants acted legally in all respects. We accept the defendant's explanations that certain documents were missing due to the numerous relocation of documents occa-

sioned by DFC sale of most of FKNB assets and that other documents were either destroyed in the ordinary course of business prior to the beginning of this ligation (Thompson's notes) or were not in the files for unknown or unclear reasons (Cooney's notes) . We have found no evidence of a deliberate effort to destroy documents by the defendants.

Further, while we have found that the defendants took the most restrictive possible view of what had to be disclosed in discovery, that their positions were not so unreasonable as to constitute spoilation of the evidence. The defendants' failure to disclose the August 1990 minutes concerning the Cooney and Logsdon criminal referrals was wrong, but we hold it did not rise to the level of active concealment of the evidence. We therefore find for the defendants on this issue.

F) Tortious Interference with Contractual Relations

In connection with their breach of contract claim, the Sallees also argue that DFC tortiously interfered with the Sallees' contract for the Package Loan. In this contention the bankruptcy estate is correct. However, for the reasons discussed in connection with the bankruptcy estate's breach of contract claim, we find that DFC's interference resulted in no damage to the Sallees as it merely prevented FKNB from making yet another disastrous loan to the Sallees, which they would have been unable to service.

G) Tort of Outrage

Finally, the bankruptcy estate asserts that the defendants conduct in connection to the criminal referral of the Sallees was so unreasonable as to constitute the tort of outrage under Kentucky law. While there is some serious question as to whether the Sallees have even stated a cause of action for a tort of outrage, under the strict guidelines of Rigazio v. Archdiocese of Louisville, 853 S.W.2d 295 (Ky. 1993); Humana of Kentucky, Inc., v. Seitz, 796 W.2d 1 (Ky. 1990) and Whittington v. Whittington, 766 S.W.2d 73 (Ky. 1989), this Court finds that Thompson and the other DFC and FKNB personnel acted in good faith, for purposes of

12 C.R.F. 21.11(3), when they filed the criminal referral against the Sallees. The defendants are protected by the safe harbor provisions of 12 CFR 21.11(3) and 12 U.S.C. §3403 in making those disclosures and cannot be held liable for any damages which might have arisen from the criminal referral.

Damages

Finally we come to the final paramount issue in this case, the question of damages. In their amended counterclaim, the bankruptcy estate has requested awards of both compensatory and punitive for the actions of FKNB and DFC. The bankruptcy estate also requests the equitable subordination of the claim of FKNB, an issue we do not have to consider, given our overall damage award in this case. We shall first address the bankruptcy estate's right to compensatory damages.

I) Actual or Compensatory Damages

Under Kentucky law, if a party has been injured by a breach of contract or commission of a tort by another party, the object of compensatory damages is to place the injured party in the same position, to the best extent a monetary award can do, in which the injured party would have been had either the contract not been breached or the tort not been committed. Graves v. Winer, 351 S.W.2d 193 (Ky. 1961); SEG Emp. Credit Union v. Scott, 554 S.W.2d 402 (Ky. App. 1977).

Here, the bankruptcy estate set forth a number of theories for compensatory damages in their counterclaims against the defendants. Several of these theories are now irrelevant as this Court has rejected the estate's tort of outrage theory of damages. However, after trial, 5 major theories of recovery remain:

1) The difference between the value of the Laundromat as represented by FKNB and the actual value realized when it was sold;

2) The value of Worth Sallee's Lowes ESOP stock;

3) The federal tax liability the Sallees incurred from the sale of the Lowes ESOP stock;

4) The loss of the plaintiffs' net worth as of the time of the May 31, 1989 loan; and

5) The present value of the lost profits from the Laundromat. This Court shall address in inverse order, each of the bankruptcy estate's theories after first addressing the estate's claim for damages under its breach of contract and tortious interference with contract theories (collectively "Package Loan Theories").

A) Damages for FKNB's Breach of its Agreement to Make the Package Loan to the Sallees

Throughout this case the Sallees have complained that they were severely damaged by FKNB's failure to make the Package Loan. However this Court finds from the overwhelming weight of the evidence that had this loan been made, its only effect on this case would have been to increase the amount of debt the Sallees owed at the filing of their bankruptcy and the losses FKNB would have suffered as a result of their larger, uncollectible deficiency claims against the Sallees. As correctly stated by Cate Elston, the defendants expert, it would have been impossible for the Sallees to remain current on the debt service from the Package Loan, under any realistic revenue stream the Sallees could earn from the Laundromat and convenience store. As the Sallees suffered no injury, we find the bankruptcy estate is not entitled to any damages under the Package Loan Theories.

B) The Present Value of the Lost Profits From the Laundromat

Under this theory, the bankruptcy estate claims that its is entitled to an award of $281,000.00 representing the present value of the Laundromat. While future damages, for lost anticipated profits are available, they can only be awarded if the future profits can be determined with a reasonable certainty. See generally Dale v. Peden, 252 S.W.2d 687 (Ky. 1952). This Court declines to award these damages for two reasons. First, an award of future profits

would be duplicative of our award of the difference in value of the Laundromat, which shall be discussed below, as the primary basis of the Laundromat's value comes from an analysis of the projected future income of the property.

Second, and more importantly, this Court finds that the alleged profitability of the Laundromat, assuming either a refinanced Laundromat loan or the making of a Package Loan, is a total and utter illusion. Although in certain cases involving fraud, Kentucky Courts have awarded damages on the basis of the profits which would have been realized had all the fraudulent representations been true, See generally Dempsey v. Marshall, 174 S.W.2d 607 (Ky. 1961), here we do not believe that, given the highly speculative nature of the hypothetical profits the Sallees might have realized, that such an award is appropriate.

C) Loss of the Sallee New Worth

A second theory of compensatory damages urged by the bankruptcy estate as a basis for awarding the estate compensatory damages, is that the Sallees should be compensated for their loss of their net worth as a result of FKNB fraud and breaches of its fiduciary duty. Once again we refuse to make an award of compensatory damages because: 1) it would be duplicative of the award for the loss of Sallee's Lowes' ESOP stock, which we will discuss below; and 2) this Court accepts Cate Elsten's analysis that except for Worth Sallee's ESOP stock, the Sallees had almost no positive net worth at the time of the Sallee Loan and that what little new worth they did have was consumed by the continuing losses of their convenience store. We therefore decline to award the Sallees any damages for their lost net worth.

D) Tax liability from Sale of Lowes' ESOP Stock

Another theory advanced by the Sallees for an award of compensatory damages is that they are entitled to be reimbursed for the $55,000.00 taxes they incurred when

the Lowes' ESOP stock was sold. While we agree with the Sallees that FKNB breached its fiduciary duty to the Sallees and defrauded them when Logsdon tricked the Sallees into selling the ESOP stock by promising to replenish Worth Sallee's IRA with the proceeds of the Package Loan, we cannot agree that the bankruptcy estate proved that this tax liability occurred when the stock was sold. As noted by this Court in its factual findings, Sallees attempted assignment of the stock to Hardin County, prior to the Sallee Loan. This attempted assignment could have triggered the Sallees' tax liability on their ESOP stock just as well as the actual sale. Since the bankruptcy estate failed to prove the actions of FKNB caused the Sallees to incur the tax liability, this Court cannot hold FKNB responsible for these adverse tax consequences.

E) The Lost Value of the Sallees' ESOP Stock

The bankruptcy estate's claim for damages arising from FKNB's misrepresentations to the Sallees about the nature and existence of Worth Sallee's IRA and their actions in convincing Sallee to sell his ESOP stock, unlike the previously discussed theories of recovery, has high merit. This Court finds, as a matter of fact, based upon its review of the facts and the testimony of the Sallees, that had FKNB not induced the Sallees to purchase the Laundromat or made their other false and fraudulent representations concerning the Sallees' Lowes ESOP stock, that the Sallees would have (and could have) sold the convenience store for about what they had in the business and paid off their debts without touching the Lowes' ESOP stock. Further, we find that, but for the misrepresentations made by FKNB through Logsdon, the Sallees would have properly placed their Lowes ESOP stock into a self directed IRA and left it there to grow in value. The bankruptcy estate established that the value of this stock, left to grow in an IRA would have been $1,170,000.00 as of the date of trial. We find no merit in the defendant's arguments that this amount should be reduced by either possible stock sales by the Sallees or by various taxes the Sallees would have to pay when they

ultimately withdrew the stock from the IRA. While the bankruptcy estate could not meet its burden of proof concerning FKNB's liability for adverse tax consequences of the ESOP stock, as it was actually handled, this Court finds that a properly established IRA, created through a valid rollover of the ESOP stock would have existed but for the fraud of Logsdon, Cooney and FKNB. Based upon the foregoing we shall, by separate order, award the bankruptcy estate $1,170,000.00 as compensation for the lost ESOP stock.

F) The Difference Between the Actual Value of the Laundromat and the Value of the Laundromat as Represented by FKNB

The bankruptcy estates' final theory for compensatory damages is that it is entitled to a judgment against FKNB in the amount of $549,999, representing the difference between the $726,000.00 value of the Laundromat represented by FKNB's final appraisal on the Laundromat and the price $176,001.00 obtained for the Laundromat when it was sold in a foreclosure proceeding conducted through the Bankruptcy Court. As noted by the Kentucky Supreme Court in the case of Webb v. Verkamp Corp., 254 S.W.2d 717 (Ky. 1953), a proper measure of damages for fraud is the difference between the value represented for the property and the reasonable market value of the property. Here, although we could find the damages to be $421,000.00 representing the difference between the false Banet appraisal and Baumgardner's reasonable $305,000.00 appraisal, we believe the actual sale price of the property is a better representation of the damages suffered by the Sallees and the bankruptcy estate, given the fact that the sale price forms the basis of the defendant's deficiency claim against the Sallees and the bankruptcy estate. While the defendants claim that the foreclosure sale in this case does not reflect the fair market value of the Laundromat, the defendants offered no evidence that they either attempted to purchase the property for a higher credit bid price or have reduced their claim against the estate to reflect the actual

value of the liquidated collateral. Therefore by separate order, this Court shall award the bankruptcy estate $549,999.00 as compensation for the difference in the value of the Laundromat.

II. Punitive or Exemplary Damages

At the present time, KRS 411.184 and 411.186 govern awards of punitive damages in all Kentucky cases they provide:

> § 411.184 Definitions — Punitive damages — Proof of punitive damages.
>
> (1) As used in this section and KRS 411.186, unless the context requires otherwise:
>
> (a) "Oppression" means conduct which is specifically intended by the defendant to subject the plaintiff to cruel and unjust hardship.
>
> (b) "Fraud" means an intentional misrepresentation, deceit, or concealment of material fact known to the defendant and made with the intention of causing injury to the plaintiff.
>
> (c) "Malice" means either conduct which is specifically intended by the defendant to cause tangible or intangible injury to the plaintiff or conduct that is carried out by the defendant both with a flagrant indifference to the rights of the plaintiff and with a subjective awareness that such conduct will result in human death or bodily harm.
>
> (d) "Plaintiff' means any party claiming punitive damages.
>
> (e) "Defendant" means any party against whom punitive damages are sought.
>
> (f) "Punitive damages" includes exemplary damages and means damages, other than compensatory and nominal damages, awarded against a person to punish and to discourage him and others from similar conduct in the future.
>
> (2) A plaintiff shall recover punitive damages only upon proving, by clear and convincing evidence, that the defendant from whom such damages are sought

acted toward the plaintiff with oppression, fraud or malice.

(3) In no case shall punitive damages be assessed against a principal or employer for the act of an agent or employee unless such principal or employer authorized or ratified or should have anticipated the conduct in question.

(4) In no case shall punitive damages be awarded for breach of contract.

(5) This statute is applicable to all cases in which punitive damages are sought and supersedes any and all existing statutory or judicial law insofar as such law is inconsistent with the provisions of this statute.

§ 411.186 Assessment of punitive damages.

(1) In any civil action where claims for punitive damages are included, the jury or judge if jury trial has been waived, shall determine concurrently with all other issues presented, whether punitive damages may be assessed.

(2) If the trier of fact determines that punitive damages should be awarded, the trier of fact shall then assess the sum of punitive damages. In determining the amount of punitive damages to be assessed, the trier of fact should consider the following factors:

(a) The likelihood at the relevant time that serious harm would arise from the defendant's misconduct;

(b) The degree of the defendant's awareness of that likelihood;

(c) The profitability of the misconduct to the defendant;

(d) The duration of the misconduct and any concealment of it by the defendant; and

(e) Any actions by the defendant to remedy the misconduct once it became known to the defendant.

(3) KRS 411.184 and this section are applicable to all cases in which punitive damages are sought.

Although the bankruptcy estate has challenged the constitutionality of these provisions[6], we find it unnecessary to consider this argument as even under the strict provisions of KRS 411.184 and 411.186 the bankruptcy estate is entitled to an award of punitive damages.

Under KRS 411.184 a party can only be awarded punitive damages if a plaintiff proves, by clear and convincing evidence, that the defendant who caused the damages acted toward the plaintiff with oppression, fraud or malice. KRS 411.184 (b) defines fraud as "an intentional misrepresentation, deceit or concealment of a material fact known to the defendant and made with the intent to cause injury to the plaintiff. Here, Logsdon, Cooney and FKNB deceived the Sallees throughout the Sallee Loan transaction and deliberately concealed material information about the Laundromat in order to induce the Sallees to purchase the Laundromat at an inflated price. They concealed these facts so one of FWB's related bad loans could be passed on to the Sallees, who had more assets with which to pay the loan than the various members of the Bramblett clan. Further we find that Logsdon and Cooney intended to harm the Sallees by having them purchase a vastly overvalued Laundromat. This Court rejects the argument that this statute requires proof of an actual evil, premeditated plot by Logsdon and Cooney to destroy the Sallees financially before an award of punitive damages can be made. Rather the objective factors of this case prove beyond any doubt that both Logsdon and Cooney knew, for a certainty, that the Sallees would be harmed by obtaining the Sallees Loan to purchase the Laundromat at a price greatly exceeding its value.

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[6] It is interesting to note that the Kentucky Supreme Court, in an opinion yet to be finalized has questioned the constitutionality and interpretation of these provisions. See Williams v. Wilson, Case No. 96-SC-1122 D6 (Ky. April 16, 1998) (Not a final opinion).

Further, this Court finds that FKNB can be held liable for the various acts of Logsdon and Cooney as officers of FKNB as the corporation specifically authorized all of the loans, security interests and other lending actions of Logsdon and Cooney in connection with the Sallee Loan until at least December of 1989 when Yates and DFC first discovered evidence of the true state of FKNB commercial lending operations. This constitutes ratification of Logsdon's and Cooney's actions.

We now turn to the calculation of FKNB's liability for punitive damages. Here, using the five factors set forth in KRS 411.186(2), we conclude that significant punitive damages should be assessed against FKNB.

First, at the time the Sallee Loan was made, it was clear that FKNB's misconduct would devastate the Sallees financially, as the Laundromat clearly could not service its massive debt against it. KRS 411.186(a).

Second, it is clear that both Logsdon and Cooney were aware of the virtual certainty of the Sallees' default on the loan and went to great lengths to have the Lowes ESOP stock placed with FKNB as collateral for this doomed loan. KRS 411.186(b) .

Third, while we agree that FKNB did not greatly profit from Logsdon and Cooney's fraud, FKNB did get $100,000.00 from the sale of the ESOP stock. Further, we see no reason why parties which are part of incompetent fraudulent schemes should be treated with significantly greater leniency than parties who are part of successful frauds. This factor mitigates toward a slight reduction in the damage award. KRS 411.186(c).

Fourth, Logsdon, Cooney and FKNB went to great lengths to deny and conceal their conduct from the time the loan was made until well after both Logsdon and Cooney were terminated. Indeed, FKNB did not willingly disclose their criminal referral of Logsdon and Cooney until ordered to do so by this Court. KRS 411.186(d).

Finally, there is no evidence before this Court that FKNB took any steps to remedy its misconduct toward the

Sallees, other than terminating Cooney and Logsdon to prevent them from making any more loans of the kind discussed in this opinion.

With the above factors all taken into account, this Court believes that punitive damages, in the amount of 75% of the above awarded compensatory damages of $1,719,999.00, or $1,289,999.25, are appropriate given the fraud and breaches of fiduciary duty FKNB is guilty of in the above case. We hold that this award meets the constitutional guidelines under Kentucky law discussed by the Kentucky Supreme Court in, Hanson v. American National Bank, 865 S.W.2d 303 (Ky. 1993) and federal due process requirements set forth by the U.S. Supreme Court in, BMW of North America, Inc. v. Gore, 517 U.S. 559 (1996); TXO Production Corp. v. Alliance Resources Corp., 509 U.S. 443 (1993). Based upon these findings, this Court shall enter by separate order a judgment against FKNB in favor of the bankruptcy estate in the total amount of $3,009,998.25.

/s/ Henry H. Dickinson
Henry H. Dickinson
U.S. Bankruptcy Judge

Louisville, Kentucky
September 15, 1998 ph
Entered: September 15, 1998

[EXHIBIT A]

February 11, 1988

TO WHOM IT MAY CONCERN:

The Fort Knox National Bank has had banking experience with Mr. Fred W. Bramblett of 1361 N. Dixie, Radcliff, Kentucky, since 1983. Experience in our bank has been with lines of credit, home construction loans, working lines of capital and the financing of the purchase of a real estate company. Various corporation identities have been used but all loans have been guaranteed personally by Mr. Bramblett.

High credit that we have extended has been $500,000.00 and all credit experience has been satisfactory.

Mr. Bramblett has had deposit relationships with our bank over the same period of time and all of these accounts have been satisfactory. Average deposit balances have been high five figure balances.

If you should have any questions regarding this matter, please do not hesitate to contact us.

Sincerely,

/s/ Kenneth Logsdon
Kenneth Logsdon
Senior Vice President

KL/sb

FINANCIAL STATEMENT

BANK OF ELIZABETHTOWN
ELIZABETHTOWN, KENTUCKY 42701

FK01592

Date 6-5-88 ☐ Individual ☐ Joint ☒ Business

Name WORTH A SALLEE Birth Date 4-18-53

Address 1227 JOHNS TOWN RD. City ELIZABETHTOWN State KY Zip 42701

Taxpayer I.D./Soc. Sec. No. 308-62-1022 Phone 502-737-1659 No. of Dependents 4

Occupation or Type of Business STORE MANAGER

ASSETS: Where Held	Amount (Omit Cents)	LIABILITIES: Owed To/Collateral	Mo. Pmt.	Amount (Omit Cents)
Checking 1ST FEDERAL / BANK OF ETOWN	$ 3500.00	Accounts Owed:	$	$
Savings	—			
$	—			
Stocks LEWIS CO 81 SHRS	$ 1824.00			
Bonds	—			
Notes & Accounts Receivable	—			
Auto. Year 88 Make OLDSMOBILE	$ 15,000.00	Loans Owed:		
Car 85 Make NISSAN (TRK)	$ 6,000.00	LIBERTY NATIONAL (TRUCK)	$ 141.43	$ 5500.00
Other Vehicles	—			
Inventory, Livestock	—	GMAC (CAR)	$ 337.66	$ 14,000.00
Equipment, Fixtures	—			
Personal Property HOUSEHOLD FURN	$ 12,500.00	BANK of ETOWN		
JEWELRY	$ 8,500.00	(SIGNATURE NOTE)	—	$ 10,000.00
	—	Real Estate Mortgages Owed:		
Real Estate HOUSE CARDINAL CRK	$ 98,000.00	1ST FEDERAL (HOME)	$ 582.42	$ 72,000.00
Cost $ 92,000.00				
Real Estate LOT - ROC VALLEY	$ 12,000.00	MERCURY FINANCE (LOT)	$ 133.34	$ 5200.00
Cost $ 11,000.00		Other Liabilities: (Itemize)		
RETIREMENT FUND 100% VESTED		Unpaid Taxes		
ESOP - (5353 SHRS. LOWES STOCK) (CASH 2255.44)	$ 132,698.00			
PROF SHARE (1183 SHRS. LOWES STOCK) (CASH/MUT FND)	$ 75,116.00	Total Liabilities		$ 106,700.00
ESOP01 - CASH/MUTUAL FUND	$ 3439.00	Net Worth: (Capital $)		$ 211,870.00
Total Assets	$ 318,570.00	Total Liabilities & Net Worth		$ 318,570.00

Does Real Estate is in Name of: WORTH A. AND SANDRA M SALLEE

Are you a co-maker, endorser, or guarantor on any loan or contract? Yes ☐ No ☒ If "Yes," for whom? To whom?

Is there any unsatisfied judgment against you? Yes ☐ No ☒ Amount $ If "Yes," to whom owed?

Have you been declared bankrupt in the last 14 years? Yes ☐ No ☒ If "Yes," where?

Other Comments—(e.g. liability to pay alimony, child support, separate maintenance. Use separate sheet if necessary.)

INCOME. Alimony, child support, or separate maintenance income need not be revealed if you do not wish to have it considered as a basis for repaying this obligation. Salary/Wages $ 45,000.00 Other $ per year

LIFE INSURANCE. Face Value $ Beneficiary

I/we certify that the information stated in this financial statement is true and correct to the best of my/our knowledge. You are authorized to check my credit and to obtain a credit report.

Worth A Sallee 6/5/88
Signature Date

P 004141

Co-Signature Date

FK00110

LOAN PROPOSAL SUMMARY SHEET

March 30, 1989
DATE

$142,000.00 Amount of Loan	11.00% Interest Rate	Working Capital Purpose
Commerical Type of Loan	20 Year Amortization 2 Year Balloon Terms	23 Payments at $1,465.70 1 Balloon of $139,084.60 Repayment Schedule
Bramblett, Fred Name, Last, First, MI	Phone	415-40-8343 SSN
Rte #6 P. O. Box 107 Street	Elizabethtown City	Kentucky 42701 State
Bramblett, Pearl Spouse, Last, First, MI	Phone	SSN
Street	City	State
Corporate Name or DBA	Phone	Tax I.D.#
Street	City	State

Business Experience

ST ALL OTHER PRINCIPALS NOT IN 3 and/or 5 ABOVE

SCR ION AND VALUE OF COLLATERAL

ortgage on commercial real estate with an appriased value of $647,500 X 80% = $518,000.00
ess first mortgage of $369,535.76 = $148,464.24

Fort Knox National Bank

TAL ASSETS	TOTAL LIABS	NET WORTH	STATEMENT DATE	DEPOSITS	LOANS	DATE
94,500.00	126,000.00	568,500.00	2-5-88	$54,555.64	369,984.52	3-29-89

P 000290

[redacted]

COME

Exhibit D

CREDIT REFERENCES FK00111
Inquires made with results

YES NO

LOAN CONDITIONS AND ESSENTIAL FACTORS

Mr. Bramblett has approached our bank for a loan in the amount of $142,000.00. The purpose of the loan is working capital.

The loan will be set up on a 20 year amoritization, 2 year balloon. The payments will be 23 at $1,465.70 and one balloon of $139,084.60. The interest rate will be 11%.

Collateral will be a mortgage on real estate located in Elizabethtown with an appraised value of $647,500 X 80% = $518,000.00 less first mortgage of $369,535.76 = $148,464.24.

The Committee hereby approves this loan for a two year commitment only. Payment will be based on a 20 year amoritization.

The committee hereby approves exception to policy on legal lending limit of ~~$00,000.00~~ $18,000. 3-30-89 3-30-89 3/30/89

LOAN OFFICER'S COMMENTS

Recommended Approval Victor L Cooney

COMMITTEE COMMENTS

APPROVAL

Marilyn Crowe Member	3-30-89 Date
[illegible] Member	3-30-89 Date
[illegible] Member	3-30-89 Date
Member	Date

P 000291

CHIEF EXECUTIVE OFFICER

30 Mar 89
Date

FK00114

FRED BRAMBLETT & PEARL BRAMBLETT
Rt. 6, P.O. Box 107
Elizabethtown, Ky. 42701

FINANCIAL STATEMENT

February 5, 1988

ASSETS

Cash on Hand	53,000
Home Elizabethtown, 2100 square feet	89,000
Household Items (guns, jewelry, paintings, prints, gold)	36,000
½ Interest, Mobile Home Park	350,000
One Acre Lot on Lake Santee, Indiana	15,000
1983 Oldsmobile Regency	8,200
1987 Chevrolet Silverado	13,500
11 Lots Rolling Oaks S/D, Radcliff	40,500
13 Mobile Homes	78,000
TOTAL ASSETS	694,500

LIABILITIES

First Federal Savings, Home	61,000
Dick Demuiter, Mobile Home Park	62,000
Personal Loan, FKNB	3,000
TOTAL LIABILITIES	126,000

NET WORTH 3/30/89 568,500

YEARLY INCOME

Army Retirement	11,820
Mobile Home Park	32,000
Personal Employment	56,000
TOTAL YEARLY INCOME	99,820

[redacted]

Pearl Bramblett

Pearl Bramblett

Fred Bramblett

P 000284

AGREEMENT

THIS AGREEMENT made and entered into this 31st day of May, 1989, between WORTH A. SALLEE and SANDRA SALLEE, husband and wife, hereinafter referred to as the MORTGAGOR, and the FORT KNOX NATIONAL BANK, hereinafter referred to as the BANK,

WITNESSETH:

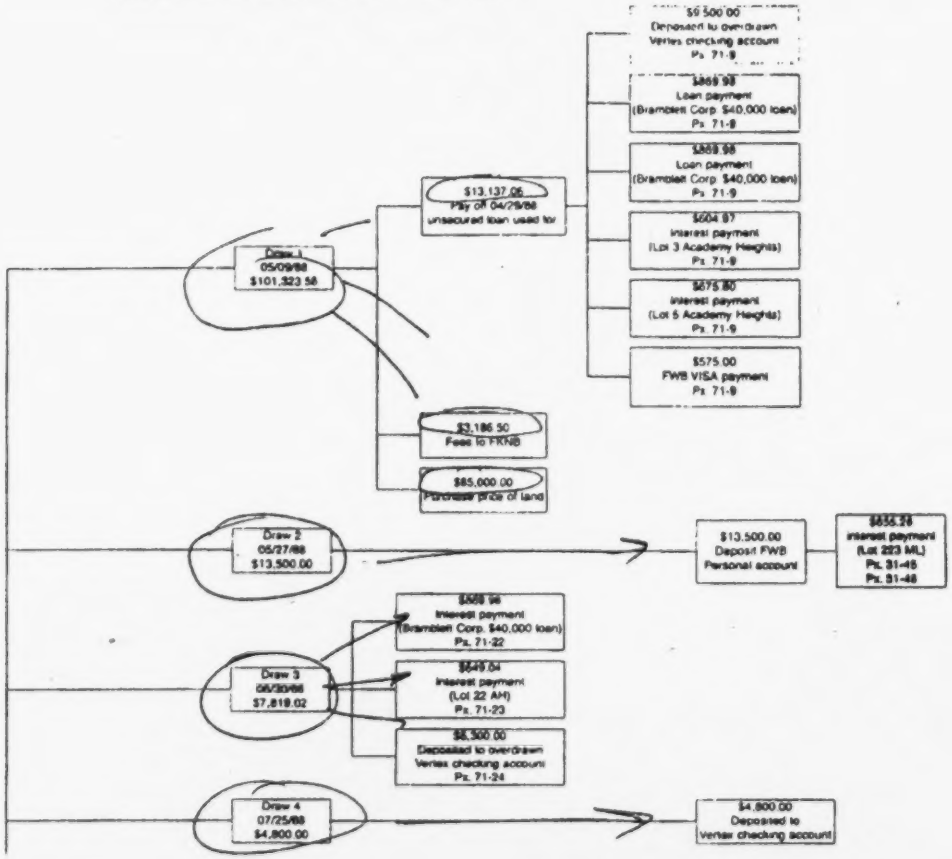
IN ORDER to secure a loan in the amount of $575,000.00. granted to Worth A. Sallee and Sandra Sallee, husband and wife, from Fort Knox National Bank, as evidenced by a mortgage dated May 31, 1989, to purchase property located at 602 Westport Road, Elizabethtown, Kentucky, also known as Lot 13 Wiselan Subdivision, Section I, the receipt of which is hereby acknowledged, the MORTGAGOR hereby agrees to leave $100,000.00 due them from a Lowe's Company Employee Stock Ownership Plan on deposit with said BANK, in either a certificate of deposit or an IRA account, until such time as the abovementioned indebtedness, Loan No. 10141707-81, is paid in full. When the $575,000.00 indebtedness has been paid in full, the BANK will release said $100,000.00 to the MORTGAGOR upon request. It being understood that if the MORTGAGOR defaults on said loan, and the BANK proceeds to foreclose on same, the said $100,000.00 will be used to offset the indebtedness due the BANK.

Witness the hand of the MORTGAG0R this 31st day of May, 1989.

/s/ Worth A. Sallee
Worth A. Sallee

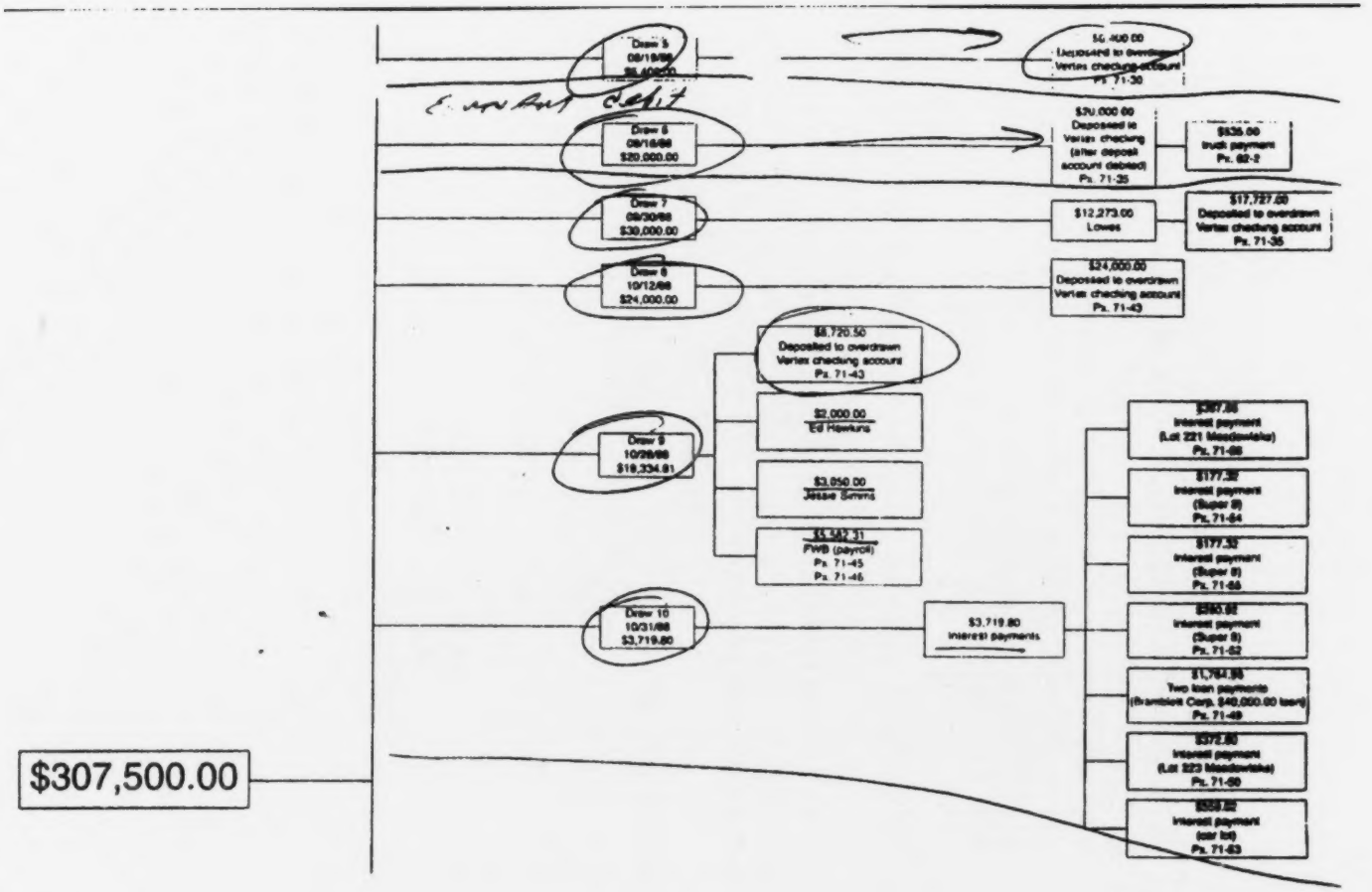
/s/ Sandra Sallee
Sandra Sallee

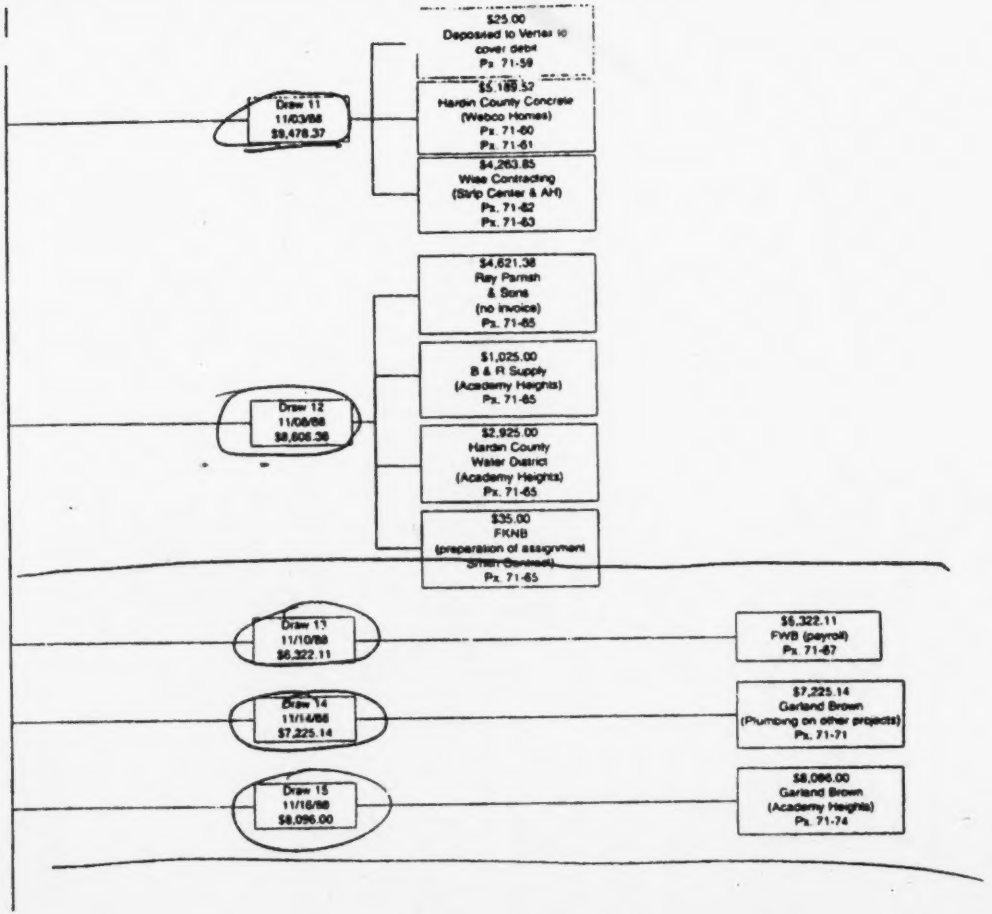
Disbursements of $307,500.00 Stri nter Loan

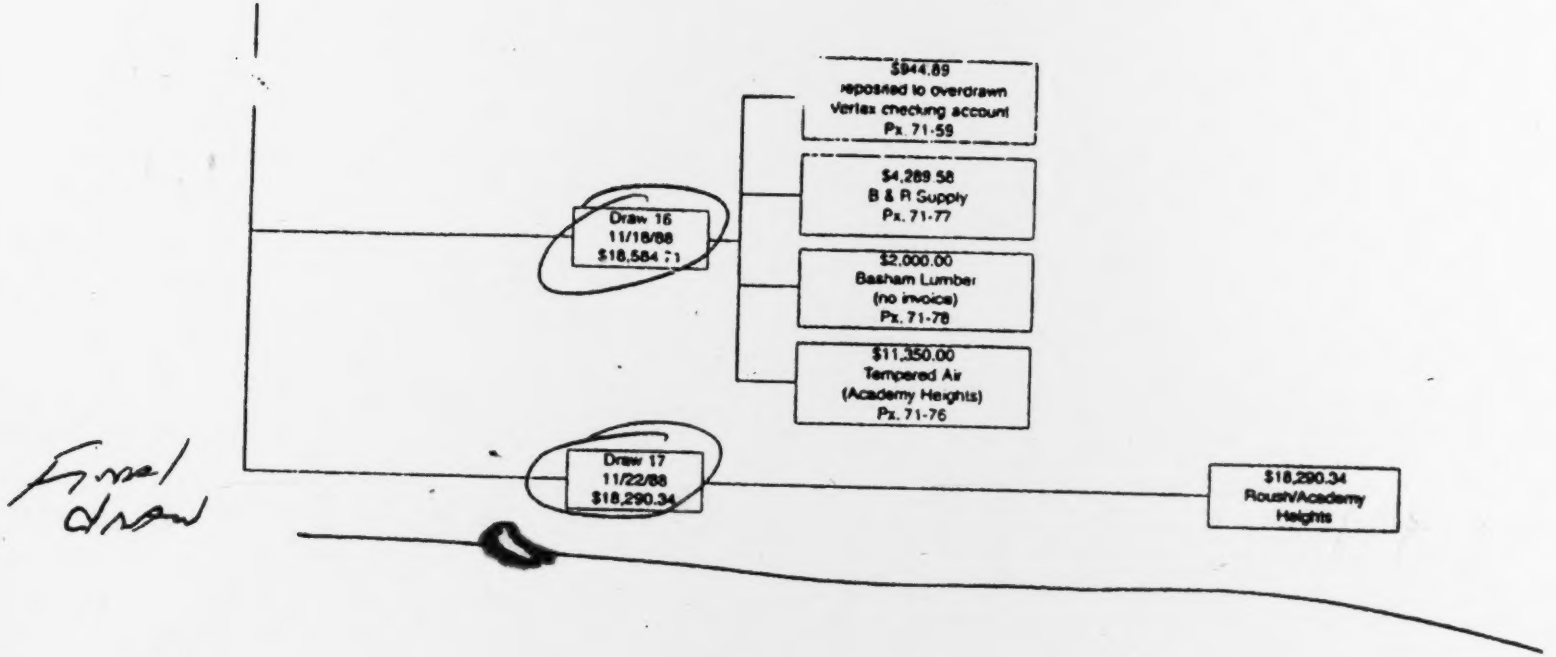


123a

BEST AVAILABLE COPY


$307,500.00
Draw 5
08/19/98
Draw 6
08/16/98
$20,000.00
Draw 7
09/30/98
$30,000.00
Draw 8
10/12/98
$24,000.00
Draw 9
10/28/98
$19,334.81
Draw 10
10/31/98
$3,719.80
$30,000.00
Deposited to Vertex checking account
Pr. 71-35
$835.00
truck payment
Pr. 82-2
$12,273.00
Lowes
$17,727.00
Deposited to overdrawn
Vertex checking account
Pr. 71-36
$24,000.00
Deposited to overdrawn
Vertex checking account
Pr. 71-43
$8,720.50
Deposited to overdrawn
Vertex checking account
Pr. 71-43
$2,000.00
Ed Hawkins
$3,050.00
Jessee Simms
$5,562.31
PWB (payroll)
Pr. 71-45
Pr. 71-46
$3,719.80
interest payments
$387.50
interest payment
(Lot 221 Meadowlake)
Pr. 71-58
$177.32
interest payment
(Super 8)
Pr. 71-64
$177.32
interest payment
(Super 8)
Pr. 71-66
$265.98
interest payment
(Super 8)
Pr. 71-62
$1,764.98
Two loan payments
(Bramblow Corp. $40,000.00 loan)
Pr. 71-49
$372.50
interest payment
(Lot 223 Meadowlake)
Pr. 71-60
$359.32
interest payment
(car lot)
Pr. 71-63


$25.00
Deposited to Veritas to
cover debit
Pg. 71-59
Draw 11
11/03/88
$9,478.37
$5,189.37
Hardin County Concrete
(Webco Homes)
Pg. 71-60
Pg. 71-61
$4,263.85
Wise Contracting
(Strip Center & AH)
Pg. 71-62
Pg. 71-63
$4,621.38
Ray Parrish
& Sons
(no invoice)
Pg. 71-65
$1,025.00
B & R Supply
(Academy Heights)
Pg. 71-65
Draw 12
11/08/88
$8,606.38
$2,925.00
Hardin County
Water District
(Academy Heights)
Pg. 71-65
$35.00
FKNB
(preparation of assignment
Pg. 71-65
Draw 13
11/10/88
$6,322.11
$6,322.11
FWB (payroll)
Pg. 71-67
Draw 14
11/14/88
$7,225.14
$7,225.14
Garland Brown
(Plumbing on other projects)
Pg. 71-71
Draw 15
11/16/88
$8,086.00
$8,086.00
Garland Brown
(Academy Heights)
Pg. 71-74


$944.89
reposted to overdrawn
Vertex checking account
Px. 71-59
$4,289.58
B & R Supply
Px. 71-77
$2,000.00
Basham Lumber
(no invoice)
Px. 71-78
$11,350.00
Tempered Air
(Academy Heights)
Px. 71-76
Draw 16
11/18/88
$18,584.71
Draw 17
11/22/88
$18,290.34
$18,290.34
Roush/Academy
Heights
Final
draw

STATE OF KENTUCKY)
COUNTY OF HARDIN)

Subscribed sworn to and acknowledged before me this 31st day of May, 1989, by WORTH A. SALLEE and SANDRA SALLEE, husband and wife.

/s/ Lois R. Hardesty
NOTARY PUBLIC STATE OF
KENTUCKY AT LARGE

My commission expires: 3/29/90

THIS INSTRUMENT PREPARED BY:
/s/ John L.
COLLIER ARNETT QUICK & COLEMAN
128 W. DIXIE AVENUE
ELIZABEHTOWN, KY 42701